

## U.S. LARGE-CAP & MID-CAP BANKS

# Our Comment Letter to FASB on Its Recent Mark-to-Market Proposal

We are sending the Financial Accounting Standards Board (FASB) a comment letter with respect to its Proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. In our view, FASB's proposal could significantly affect the accounting for loans, debt and equity securities, and many other types of financial instruments. We have reservations about portions of the proposal that require all financial instruments to be marked to market, particularly with respect to loans that were originated with the intent to be held to maturity. We believe that possible outcomes could be to reduce transparency and introduce misleading volatility into banks' earnings and capital. Furthermore, based on our research, we do not believe investors are in favor of such changes.

- On June 18, 2010, we asked the recipients of our daily Bank Brief to answer 'yes' or 'no' to the question "Do you agree with FASB's recent exposure draft on fair value accounting and credit loss recognition?" We received 102 responses from institutional investors, with 92, or 90%, responding 'no' they do not agree with the proposal. Of the 32 bank executives that responded, all 32 responded 'no.'
- While mark-to-market accounting for trading assets makes sense to us, the banking business model is predicated on making loans for their contractual cash flows. The majority of banks originate loans with the intent of holding the asset to maturity. As such, what matters is not how the loan is valued in the marketplace, but if the bank will recapture its principal and earn interest over the life of the loan.
- We are concerned this proposal would reduce the reliability of financial statements. Many loans have no readily discernable market in which to determine fair value, thus banks could see a significant increase in "Level 3" assets, a designation that investors appear to view with a fair degree of skepticism.
- We also believe that these rules could intensify downturns, as it is our view that pro-cyclicality exacerbated the financial crisis. Capital rules, liquidity rules, FDIC insurance premiums and mark to market accounting all subject banks to increased pro-cyclicality, something we believe FASB should try to reduce.
- FASB's approach seems to counter that of the International Accounting Standards Board (IASB), despite the recent acknowledgement by both these bodies, as well as the G-20 and the Basel Committee on Banking Supervision, that the convergence of accounting and capital standards is in order.

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Investors should consider this report as only a single factor in making their investment decision.

PLEASE SEE ANALYST(S) CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 8.

### INDUSTRY UPDATE

#### U.S. Large-Cap Banks

1-POSITIVE

Unchanged

#### U.S. Mid-Cap Banks

2-NEUTRAL

Unchanged

#### U.S. Large-Cap Banks

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File Reference: No. 1810-100 Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

Dear Mr. Golden:

We appreciate FASB reaching out to us for our comments on the Proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* the same evening it was released to the public, acknowledging up-front that since these proposals could significantly affect the accounting for loans, debt and equity securities, and many other types of financial instruments, analyst/investor input would weigh heavily in the Board's re-deliberations on what—if anything—will become the final standard. We would also like to thank you again for speaking on a panel that we hosted for roughly 400 institutional investors and bank executives on this topic. We also found our phone conversation with FASB board member Marc Siegel helpful in understanding FASB's stance on this issue.

We have been covering bank equities on the sell-side for global bulge bracket firms for more than 15 years. It should be noted that opinions expressed in this letter are our own, in our capacity as equity research analysts, and do not necessarily reflect the views of Barclays PLC or Barclays Capital. Our current coverage universe encompasses 26 large-cap and mid-cap banks, including all 20 banks currently included in the S&P 500 index. As a research analyst, a company's financial condition—and transparent and consistent financial statements—is crucial. As such, we have some reservations with portions of FASB's proposal that require all financial instruments to be marked to market, particularly with respect to loans that were originated with the intent to be held to maturity. We believe possible outcomes could be to reduce transparency and introduce misleading volatility into banks' earnings and capital. Below we make several points that we believe support this view.

### **Bank Stock Investors Don't Appear to Be in Favor**

Our recent conversations with the largest bank stock equity investors and executives at the largest banks, as well as recent commentary from several senior regulators, suggest the majority of these constituents oppose numerous aspects of the proposal. In fact, on June 18, 2010, we asked the recipients of our daily "Bank Brief" e-mail to answer 'yes' or 'no' to the question "Do you agree with FASB's recent exposure draft on fair value accounting and credit loss recognition?" We received 102 responses from institutional investors, with 92, or 90%, responding 'no' they do not agree with the proposal. Of note, of the remaining 10

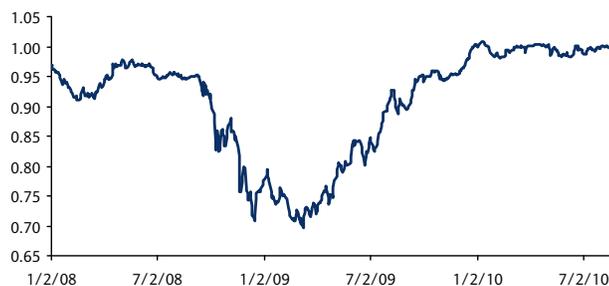
that responded 'yes', half were mutual funds and half were hedge funds. Of the 32 bank executives that responded, all 32 responded 'no'. If the most sophisticated long-term bank stock investors do not want this, we would be surprised to see FASB continue down this path. Furthermore, if the standards were adopted, against shareholder wishes, we are concerned that the increased volatility of earnings and capital could make investors put pressure on banks to take measures to reduce volatility. As such, banks may reduce the amount or type of loans they make and/or alter the products offered. Banks may want to avoid loans with long-term/fixed interest rates or loans to lower-quality borrowers. While perhaps not an immediate concern of FASB's, we believe it does have serious potential ramifications that need to be considered.

### Inconsistent with Bank's Business Model

While mark-to-market accounting for trading assets makes sense to us, the banking business model is predicated on making loans for their contractual cash flows. Almost two-thirds of the banking industry's \$12 trillion of earning assets are loans. The majority of banks originate these loans with the intent of holding the asset to maturity. As such, what matters is not how the loan is valued in the market place, but if the bank will recapture its principal and earn its interest over the full life of the loan. The market value of the loan is only relevant if the bank wishes to sell the loan, which is typically not the case. Also, unlike securities, which in several instances are readily tradable, most loans are not. Each loan has different collateral, repayment terms and guarantees. As such, we question the reliability of using fair value as the basis for financial statements.

The LCDX is a basket of 100 credit default swaps referencing first-lien loans, that trade in the secondary leveraged loan market. While it is not representative of the average regional banks loan portfolio, we will use it as an example. As shown in Figure 1, the LCDX dropped 28% from 0.97 in mid-1998 to as low as 0.70 during 1Q09, before rebounding to more than 1.0 by 1Q10. The movement in this index, for example, while perhaps indicative of the value of loans in the marketplace, had no bearing on the ultimate profitability of the loans that banks held to maturity. This price does not (and did not) represent the cash the bank received. Even if a loan repayment comes into question, banks tend to restructure the credit (an area that does need more transparency, but we'll save that discussion for another day), as opposed to selling the credit. Furthermore, banks have material non-public information with respect to the loans they originate and their associated collateral. Additionally, given their business model, the value of the loan would not necessarily reflect the value of the entire relationship that a bank may have with a specific customer.

Figure 1: LCDX, 2008-Current



Source: Markit, Barclays Capital

## Difficulties in Marking Loans to Market

We are concerned that this proposal would reduce the reliability of financial statements. Many loans have no readily discernable market in which to determine fair value, thus banks could see a significant increase in “Level 3” assets, a designation that investors appear to view with a fair degree of skepticism. While one of the FASB’s objectives is to reduce inconsistencies in the reporting of financial instruments, we believe this proposal would increase them. We believe it’s highly likely that, given the heterogeneous nature of loans and lack of ready market, loans will not be valued consistently across organizations (other than new conforming residential mortgages, maybe).

Our main focus is on how the loan will perform over the life of the credit, but we do believe the market’s view is of interest. However, footnote disclosures—and not on the face of the financial statement—seem to be more appropriate, in our view. Still, enhancements appear to be necessary here as well. Figure 2 shows banks’ fair value disclosure for loans, under FAS 107, as reported in the 2Q10 Form 10-Q filings. While the fair value of the median bank’s loan portfolio is at the carrying value, the range is wide. Of note, the fair value of RF’s loan portfolio is a full 14% below its carrying value, while loans are marked at par at BBT and STI, despite all three of these banks operating in similar geographies with similar loan mixes. In fact, the difference at RF exceeds its tangible equity. While methodology differences likely account for at least a portion of the variation, we believe the current guidance does not solve for this.

**Figure 2: Loan Carrying Value vs. Fair Value (as required by SFAS 107), 2Q10**

	2Q10		Fair Value vs. Carrying Value Difference		
	Carrying Value	Fair Value	in dollars	in %	as % of TCE
RF	\$80,737	\$69,685	(\$11,052)	-14%	-136%
MI	\$39,801	\$35,783	(\$4,018)	-10%	-92%
KEY	\$51,115	\$47,322	(\$3,793)	-7%	-53%
FHN	\$16,373	\$15,370	(\$1,003)	-6%	-50%
HBAN	\$35,568	\$34,049	(\$1,519)	-4%	-50%
FITB	\$72,498	\$70,243	(\$2,255)	-3%	-30%
WFC	\$728,016	\$708,667	(\$19,349)	-3%	-26%
BAC	\$889,799	\$874,459	(\$15,340)	-2%	-13%
C	\$643,500	\$632,500	(\$11,000)	-2%	-9%
TCB	\$14,759	\$14,572	(\$187)	-1%	-14%
MTB	\$50,167	\$49,580	(\$586)	-1%	-16%
SNV	\$22,508	\$22,248	(\$261)	-1%	-11%
ZION	\$36,629	\$36,329	(\$300)	-1%	-9%
STT	\$10,203	\$10,123	(\$80)	-1%	-1%
BBT	\$99,952	\$99,462	(\$490)	0%	-5%
FIBK	\$4,448	\$4,429	(\$19)	0%	-4%
EWBC	\$13,453	\$13,410	(\$44)	0%	-3%
JPM	\$663,600	\$663,300	(\$300)	0%	0%
STI	\$112,925	\$112,925	\$0	0%	0%
CMA	\$39,635	\$39,638	\$3	0%	0%
USB	\$186,264	\$186,568	\$304	0%	2%
PNC	\$142,377	\$142,785	\$408	0%	2%
TCBI	\$4,388	\$4,401	\$13	0%	3%
BK	\$33,271	\$33,377	\$106	0%	1%
NTRS	\$27,039	\$27,267	\$228	1%	4%
CYN	\$11,193	\$11,495	\$302	3%	22%
<b>Sum</b>	<b>\$4,030,217</b>	<b>\$3,959,985</b>	<b>(\$70,232)</b>	<b>-2%</b>	<b>-12%</b>
<b>Median</b>				<b>-1%</b>	<b>-7%</b>

The above figure is reproduced from a piece we published on August 24, 2010 titled “2Q10 10-Q Review & Other Current Events”; Source: SNL Securities, Company reports, Barclays Capital

One discrepancy is how liquidity discounts get treated, particularly given that the market for many loan products is not active (or non-existent) to begin with. Interestingly, as we have published in the past (see “Fair Value & OTTI Clarity Expected Soon” on March 18, 2009; “FASB Changes On FV & OTTI - Initial Look” on April 2, 2009), in early April 2009, after

being called to testify in front of Congress, FASB itself was asked to, and ultimately did, tone down the marks that banks had to take on securities given market illiquidity concerns. Still, the market for loans is much less liquid than that for securities. Furthermore, in a financial crisis—like the one we just lived through—there is not much of a market for anything, so market prices can fall significantly below intrinsic value.

### **Transparency Reduced**

As detailed in the preceding section, with no liquid market for loans existing, requiring these assets to be marked-to-market as opposed to held at amortized cost could result in less transparency and comparability, not more. Furthermore, with FASB's having banks subtract "unrealized losses on loans/securities" from "net income" to come up with "total comprehensive income", to us, gives the implication that mark to market is the most important measurement. Placing the fair value on the face of the balance sheet amplifies the significance of it. This inherent volatility that would be unduly thrust into these numbers has the potential to reduce the comparability between two companies. Furthermore, this issue will not exist for other industries. The proposal would also understate interest income and overstate recoveries for performing assets because cash interest will almost always exceed the calculated interest income as well as the loan loss reserve. Accordingly, the excess reserve created by this approach will need to be reversed through the loan loss provision. Also, typically, analysts examine the net interest margin and loan loss provision separately when focusing on interest rate and credit risk, respectively.

### **Capital and Liquidity Concerns**

We believe this proposal has the potential to create undue volatility in bank earnings and capital. Subjecting a bank's equity to volatility to degrees that may not ultimately be realized and subjecting long-duration assets to short-term volatility could put into question a bank's capital level, which, in our view, has serious micro and macro ramifications. In addition, it would make it more difficult for banks that truly need to raise fresh capital as investor confidence would be diminished.

Furthermore, an increase in volatility, as well as Level 3 valuation techniques for loans with no readily available market, could also increase the cost of capital for all banks. While it is possible that regulators disregard fair value accounting when assessing capital, we still have reservations. Just look how quickly investors lost confidence in Tier 1 capital ratios during the crisis, despite historic emphasis on this metric by regulators. Furthermore, we would be concerned as to what impact such disclosures could have on depositors and ultimately on the liquidity of institutions.

We published Figure 3 immediately after PNC Financial Services' announcement of its acquisition of National City during 3Q08. This came shortly after JPMorgan Chase's assumption of Washington Mutual and both Citigroup's and Wells Fargo's proposals to acquire Wachovia. In it, we applied the average mark-to-market outcomes for each of the loan categories presented in the aforementioned merger presentations, weighted by each company's loan mix. Such an exercise eliminates all of the Tier 1 capital and loan loss reserves for a quarter of the banks surveyed. If one used today's more conventional Tier 1 common ratio, we estimate it would have eliminated the majority of the names presented, in addition to placing most of the rest below the current definition of well-capitalized. Bottom line, had banks had to actually run these—or somewhat similar marks—through

their capital accounts, we believe the implications would have been even more draconian than what was ultimately realized.

Figure 3: Illustrative Marks (as published on October 27, 2008)

MARKS	7%	16%	30%	4%	13%	8%	6%	9%	6%							
					Multi-	Credit	Other			Implied	Implied	Tier 1	Loan	Mark % of		
Ticker	C&I	CRE	Constr	Mortg	Family	HEL	Card	Cons	Lease	Other	Mark	Loans	Capital	Reserve	Tier 1 + LLR	
SNV	16%	25%	33%	12%	2%	6%	1%	1%	1%	3%	17%	\$28	\$5	\$3	\$0.5	139%
ZION	25%	31%	22%	10%	2%	5%	1%	1%	1%	3%	15%	\$42	\$6	\$4	\$0.6	134%
RF	18%	17%	15%	17%	2%	13%	0%	6%	2%	10%	12%	\$99	\$12	\$9	\$1.5	116%
MI	28%	16%	20%	18%	4%	5%	1%	2%	1%	5%	13%	\$50	\$6	\$5	\$1.0	114%
BBT	14%	15%	21%	28%	1%	5%	2%	10%	1%	4%	13%	\$96	\$12	\$10	\$1.4	105%
MTB	23%	24%	10%	13%	4%	9%	0%	11%	3%	3%	11%	\$49	\$6	\$5	\$0.8	105%
CMA	49%	23%	11%	5%	1%	3%	1%	1%	3%	4%	12%	\$52	\$6	\$6	\$0.7	95%
STI	21%	10%	11%	27%	1%	12%	1%	9%	5%	5%	10%	\$131	\$13	\$13	\$1.9	93%
TCB	9%	13%	3%	45%	4%	12%	0%	1%	12%	0%	8%	\$13	\$1	\$1	\$0.2	87%
FITB	28%	13%	12%	14%	1%	12%	2%	10%	5%	2%	11%	\$86	\$10	\$10	\$2.1	83%
FHN	20%	10%	17%	28%	1%	18%	1%	1%	0%	5%	12%	\$25	\$3	\$3	\$0.8	80%
KEY	28%	13%	11%	7%	1%	10%	1%	11%	12%	6%	11%	\$78	\$9	\$9	\$1.6	79%
WFC	21%	9%	5%	25%	1%	16%	6%	12%	2%	5%	9%	\$425	\$38	\$43	\$7.9	75%
USB	24%	10%	5%	18%	1%	8%	9%	11%	7%	7%	9%	\$170	\$16	\$19	\$2.8	72%
PNC	30%	13%	6%	23%	1%	10%	1%	7%	3%	5%	9%	\$75	\$7	\$10	\$1.1	67%
BAC	20%	6%	4%	29%	1%	11%	12%	7%	2%	7%	8%	\$892	\$73	\$110	\$20.3	56%
C	22%	1%	0%	24%	1%	4%	12%	16%	1%	19%	6%	\$822	\$53	\$96	\$24.0	44%
NTRS	26%	7%	2%	28%	1%	6%	0%	8%	4%	18%	7%	\$29	\$2	\$5	\$0.2	42%
JPM	27%	2%	1%	16%	0%	12%	12%	10%	1%	19%	8%	\$566	\$43	\$112	\$19.1	33%
BK	11%	2%	1%	9%	1%	1%	0%	2%	9%	66%	7%	\$51	\$3	\$11	\$0.4	29%
STT	0%	0%	0%	0%	0%	0%	0%	1%	13%	86%	6%	\$15	\$1	\$12	\$0.0	8%

The above figure is reproduced from a piece we published on October 27, 2008 titled "TARP CPP Update & PNC/NCC Laterals"; Source: Company reports, Barclays Capital, SNL Securities:

### Liability Valuation Also a Challenge

If FASB does end up using fair value accounting for the majority of financial assets, we do agree that the liability side also needs to be fair valued. However, we have concerns with this approach as well. Using the proposed alternative funds rate and re-measurement value calculation could be challenging (plus we found these terms confusing). We believe the industry has a core deposit base approaching \$6 trillion, which greatly exceeds investment grade corporate debt issuance; thus it could be difficult to get an apples-to-apples comparison here as well.

We also believe the marking to market of a company's own debt and structured notes currently creates confusion (FAS 157 and 159), with investors typically backing out these adjustments. As written, it appears that a company's debt is worth the most the day before bankruptcy, yet the amount owed never changes.

### Could Increase Pro-cyclicality

We also believe these rules could intensify downturns as it is our view that pro-cyclicality exacerbated the financial crisis. Capital rules, liquidity rules, FDIC insurance premiums and mark-to-market accounting all subject banks to increased pro-cyclicality. After closely watching bank financial statements over the past several years, we would have thought FASB—along with other bodies—would have wanted to take steps to reduce pro-cyclicality, not increase it. Of note, in addition to loan loss reserves being at their lowest level when things are best (i.e. the day before they start to get worse), the proposal now does the same thing with capital. It could also hurt the banks' ability to lend when lending is likely to be needed most. While that may not be an immediate consideration of FASB, it is a concern.

### Divergence with the IASB

While FASB proposes that all financial instruments are reported at fair value, the International Accounting Standards Board (IASB) seeks to retain some of the existing financial instruments accounting model that used a combination of fair value and amortized

cost, depending on the nature of the financial instrument. Also the recent IASB proposal does seem to recognize the importance of a company's business model when prescribing accounting rules. As such, FASB's approach seems to counter that of the IASB, the opposite of what we thought was a goal of both organizations, as well as the G-20 and the Basel Committee on Banking Supervision. We generally support the convergence efforts of the FASB and IASB, which can be seen in other areas of financial reporting (this month's leasing guidance, for example). We are surprised that the two agencies appear to be taking very different routes here (though we have concerns about their proposal as well). Furthermore, it could put U.S. companies at a competitive disadvantage with international competitors.

### **Costs Could Outweigh Expected Benefits**

We have also heard from several banks that their existing accounting, credit, deposit, security and risk management systems cannot handle the proposal, which would result in increased costs. FASB seems to acknowledge this in the proposal, as it defers implementation for smaller banks by four years. Still, we would think with larger balance sheets, it could be more difficult to achieve for the bigger banks, despite increased resources and possibly economies of scale.

### **Conclusion**

In conclusion, we do not believe the proposal—and marking loans to market in particular—improves financial reporting. We believe this proposal lacks relevancy to the banks' business model and we worry about the reliability. Still, we do believe investors and analysts alike would benefit from increased transparency, an endeavor we do hope you take on. Additional details about banks' loan portfolio composition and risk factors, valuation methods and assumptions, and sensitivity analysis for movements in key assumptions would be helpful, in our view. The rating agencies appear to receive a great deal more information than equity investors. Making more of this already prepared data readily available could benefit the market, in our view.

Furthermore, we do believe a credit impairment model that allows for earlier recognition of expected losses would be beneficial. Still, changes here appear to be needed, as we believe banks should be able to use future expectations as opposed to being limited to past events and existing conditions. It is not helpful when loan loss reserves lag losses inherent in the portfolio. We would also find it useful if originated and purchased financial assets are accounted for in the same manner, to simplify or eliminate the purchased credit impaired loans and accretable yield concepts. Also, we are generally supportive of the proposal's simplified approach to accounting for derivatives and hedging.

We appreciate the opportunity to comment on these issues. If you have any questions, please contact us at (212) 526-8580 or [jason.goldberg@barclayscapital.com](mailto:jason.goldberg@barclayscapital.com). We also wanted to inform you that we are willing to participate in the roundtable discussion that FASB plans on hosting.

Sincerely,

/s/ Jason M. Goldberg, CFA

Jason M. Goldberg, CFA

## ANALYST(S) CERTIFICATION(S)

I, Jason M. Goldberg, CFA, hereby certify (1) that the views expressed in this research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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In addition to the stock rating, we provide sector views which rate the outlook for the sector coverage universe as 1-Positive, 2-Neutral or 3-Negative (see definitions below). A rating system using terms such as buy, hold and sell is not the equivalent of our rating system. Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.

### Stock Rating

**1-Overweight** - The stock is expected to outperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

**2-Equal Weight** - The stock is expected to perform in line with the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

**3-Underweight** - The stock is expected to underperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

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