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Fair-value Accounting Presents Problems When Applied to Core Deposits

While large portions of FASB's proposal on financial instruments make a lot of sense and will help mitigate risk, there are pieces that just don't work well from an implementation perspective. I'm certain many of the comment letters you've received have focused on asset valuation, but some of the biggest problems with fair-value accounting come with its application to core deposits. We at BancVue have experience working with over 600 community banks and credit unions on core deposits and can provide some recommendations around valuation mechanisms.

Fair-value becomes problematic when it's applied to liabilities like core deposits for several reasons, including the lack of a maturity date (uncertain customer attrition), the difficulty in comparing the true cost of checking accounts, and the fact that it's difficult to capture the strategic value of a checking account. In fairness to FASB, the board recognizes some of the problems and has proposed a formula for estimating the cost of these deposits at the average of the closest alternative funding source and the true cost of deposits.

Cost of Deposits Approach is a Big Improvement over Cost of Funds

The concept of a "true cost of deposits" vs. the more traditional "cost of funds" measurement is essentially a movement towards recognizing the real cost or value of relationship oriented products like checking accounts, where non-interest income (fees) and non-interest expense (operating costs) can have more impact on product profitability than interest rates do. This is a relatively new concept in the banking industry, but it's gained increased attention in recent years. While FASB's move to a true cost of deposits approach is a huge improvement over the highly inaccurate cost of funds measurement, there's been little description of what components will go into the calculation.

Questions Need to be Answered

Some of the big questions to be answered include:

- Should cost of deposits be measured at the account, customer, product, or institution level?
- What role, if any, does branch overhead play in cost calculation?
- If labor costs are applied, how are they distributed among individual products, which may have greater or lesser reliance on branch support vs. technology?
- Given the uncertain maturity of checking account products, how will life-expectancy be calculated?

Should Cost Be Measured at the Account, Customer, Product or Institution Level?

Information management systems vary dramatically, and requiring the true cost of deposits to be measured at the account or consumer level will be extremely difficult and present an undue burden for many community banks and credit unions.

Recommendation: Measure cost of deposits at the product level. Per-account & other marginal

expenses (core processing fees, statement expense, etc.) should be tallied and divided into the number of accounts in each product to come up with a number for per-account non-interest expense.

What role, if any, should branch overhead play in cost calculation?

The actual costs of a branch are non-linear - they don't move in direct proportion to the number of accounts. Simply dividing branch overhead by the number of accounts at a branch is a flawed approach, largely due to issues with sunk costs, use, and capacity.

The physical building itself is a sunk cost – all the bricks are there, and you don't add bricks when you add a checking account. Although maintenance costs may go up a little with usage, additional costs for each checking account here are extremely low, while the cost of deciding to open the branch in the first place is substantial. It can also be difficult to decide how much of a given branch's expense goes towards various assets (loans) and liabilities (CDs and checking accounts).

Recommendation: Leave physical costs out of the cost of deposit calculation and continue to use an amortized model as you would any other building or equipment expense.

How should labor costs be allocated?

The relationship of labor costs to checking account volume follows a stair-step model – a bank or credit union doesn't hire part of a new person for every new account that opens, though as you add workload, you will have to increase staff. This should be included, and one simple and relatively accurate approach is to look at the marginal labor cost and divide it into the increase in checking account volume associated with that employee. Branch usage varies dramatically even within checking account products. Commercial accounts can involve heavy activity while retail accounts that encourage technology adoption result in reduced labor costs and shouldn't be priced at the same rate.

Recommendation:

Step 1: Sum teller labor costs across the institution (salary, bonus, benefits); divide into # of transactions for the institution to get a per-transaction labor cost.

Step 2: Multiply by the average # of transactions per account at the product level to identify per-account labor costs associated with the product.

How should life expectancy be calculated for products with indeterminate maturity?

As written, maturity isn't a direct component of FASB's calculation. However, alternate funding cost is and it's very difficult to establish an alternate funding cost without maturity. As it stands, checking accounts are likely to be compared against the Fed Funds rate, which is misleading because checking accounts are far less volatile. One key value of checking account relationships is that they stick around and are less interest rate sensitive, which is why they're referred to as core deposits. Comparing them against Fed Funds is likely to result in a misstatement of interest rate risk. While they can re-price more quickly than fixed-rate products like CDs, that's probably a closer fit for their value than Fed Funds. There are a number of complex ways to calculate life expectancy, but the simplest approach is probably the best in this case.

Recommendation:

Step 1: Divide 1 by the annual attrition rate (# accounts closed each year/avg. annual # of accounts) for each product.

Step 2: Take the resulting life expectancy, divide by 2 and compare to certificates of deposit with

the nearest maturity, rounding down.

In summary, there are definitely times where fair-market methodology makes sense, but using a fair-market approach across the board is likely to cause more problems than it's worth. Some of these problems could be mitigated, depending on the approach, but as Monsieur Guillotine might say, "It's all in the execution."

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