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Financial Companies: Fair Value Measurement

By Louisa Ho
Portfolio Analyst

Until a few months ago, stock prices of financial companies had been falling as market concerns persisted on credit quality, inadequate capital and mortgage-related exposure. Impaired financial companies made a lot of bad loans and/or were holding securities/assets that were losing value. Billions of dollars of write-offs were taken by companies across the financial sector in recent quarters, substantially eroding their capital. The market was particularly distressed earlier this year when many financial companies were deemed to have insufficient capital and the fear of bank nationalization surged. The write-offs, while painful, were necessary to more accurately reflect the risks associated with the financial companies' underlying assets. However, for some financial companies, this mark-down process was unduly exacerbated by the Statement of Financial Accounting Standard No. 157 (SFAS 157), *Fair Value Measurements*.

SFAS 157

SFAS 157, effective for fiscal years beginning after November 15, 2007, sets out guidelines for how companies should determine fair values of certain assets and liabilities. With a few exceptions, the rule affects all assets and liabilities that are required to be reported at fair value.

Since numerous significant factors depend on the value of a financial company's assets and liabilities, including valuation, capital adequacy for regulatory purposes, ability to get financing etc., SFAS 157's impact on the reported value of assets and liabilities has far-reaching implications. Its greatest impact is on the reporting for financial assets.

SFAS 157 defines fair value of an asset as the price for which the asset can be sold in an ***orderly*** transaction (i.e. not a forced liquidation or distressed sale) at the measurement date. It requires companies to classify assets that are reported at fair value into one of the following categories:

Level 1 – Assets with fair values that are based on ***quoted prices*** for ***identical assets*** in ***active markets***.

Level 2 – Assets with fair values that are based on other observable data, such as the ***quoted prices*** for ***similar assets*** in ***active*** markets.

Level 3 – Assets with fair values that are based on the reporting company's ***valuation models***.

Under SFAS 157, companies are required to maximize the use of quoted prices before using other observable data to determine fair values. Only when quoted prices and other observable data are not available, such as when the market is illiquid, should companies resort to using their own valuation models.

Since Level 3 assets are the most illiquid and their values are based primarily on the financial companies' own assumptions, they are subject to the greatest risk of manipulation and generally perceived to have the greatest potential for future write-offs. All other things being equal, the market tends to punish more severely those financial companies holding the highest concentration of Level 3 assets. While SFAS 157 does not cure the inherent uncertainty of determining fair value of Level 3 assets, it does help by mandating disclosure of the amount of Level 3 assets, so investors analyzing the company can estimate how much of the total assets is subject to manipulation.

SFAS 157's Impact on Bank Capital

As the market prices of many mortgage-related securities remain depressed and the markets for some of these securities continue to have limited trading activity, financial companies are left with no other choice under SFAS 157 than to either mark these securities down to the depressed quoted market prices (Level 1 and Level 2 assets) or, where reliable market prices are unavailable, mark the assets down based on the companies' own valuation models (Level 3 asset).

Even though SFAS 157 states that quoted prices from distressed or forced liquidation sales in ***inactive markets*** need not be used to determine an asset's fair value, it was highly unclear what qualified as distressed or forced liquidation sales or inactive markets. Some auditors argued that more than one or two sales provided a reliable market price, which should be used for determining the fair value of that particular security or similar ones. Even if active markets existed, it was nevertheless unclear what constituted "similar or comparable securities." Because of these uncertainties, many financial companies were marking their mortgage-related assets down to fire-sale prices in illiquid/inactive markets or to prices indicated by structured finance indices like the ABX and CMBX, which are thinly traded and are prone to distortion by heavy speculation. This gave rise to the unintended consequence of asset value distortions.

Spiking delinquencies and default rates, as well as inactive markets, have caused the prices of mortgage-related securities across the board to plummet, including those of the highest quality, forcing banks to take massive write-offs under SFAS 157 even when some of these securities deserve higher valuation because the underlying assets have high credit quality. As long as these securities do not need to be sold for liquidity reasons, the banks can actually hold on to them until market normalcy returns and the market prices of these securities recover to higher levels. The write-offs under SFAS 157, as formerly interpreted by many financial institutions, therefore unduly depressed their reported earnings and book values in some cases. This not only hurt their near-term profitability, credit ratings, and capital ratios, but also created further uncertainty for the health of the banking sector in general and the need for additional capital raising in a market environment that was utterly hostile to providing financing.

Recent Clarifications on SFAS 157

In a joint clarification issued by the SEC and FASB on September 30, 2008 and a FASB staff position issued shortly thereafter, guidance was provided with respect to the implementation of fair value accounting in cases when an ***active market for a security does not exist***. The guidance included the following key clarifications:

1. ***Distressed or forced liquidations sales are not orderly transactions*** and therefore are not determinative when measuring fair value.
2. It is acceptable to use a valuation technique, such as a discounted cash flow model, that incorporates current market participant expectations of future cash flows and includes the appropriate risk premiums, to measure the fair value of a security in an inactive market.
3. Unobservable inputs might be more appropriate when observable inputs might not be relevant and require significant adjustments.
4. Transactions in inactive markets may be inputs when measuring fair value but would likely not be determinative.

On April 9, 2009, FASB updated its staff position in connection with SFAS 157. This latest guidance clarifies how to determine if there has been a significant decrease in the volume and level of activity for an asset or liability, in which case further analysis is needed and a significant adjustment to the transaction or quoted prices may be necessary to estimate fair value. The guidance also helps with identifying transactions that are not orderly. If a transaction is determined as not orderly, then little weight should be placed on the transaction price when estimating fair value. If it cannot be determined whether the transaction is orderly, then the transaction price should receive less weight than other inputs when estimating fair value. With these clarifications, FASB finally fixed some of the significant ambiguities in SFAS 157 — what constitutes an inactive market and what constitutes a distressed or forced transaction; financial companies ***no longer have to mark their assets to fire-sale prices in markets that are illiquid or lack normalcy***. They are able to value their assets on a more rational basis and reflect a more accurate representation of their capital strength on their balance sheets.

Although SFAS 157's purpose of establishing a single definition of fair value and a framework for measuring fair value can improve the quality of information provided to investors, the initial interpretations and applications of the rule with regard to what qualifies as active markets and comparable assets were problematic, a situation made worse during the panicky, illiquid markets last year. Despite the credit woes being widespread, not all financial companies are subject to the same kind of high credit risk highlighted by the alarmist headlines these days. Under the early interpretations of SFAS 157, some financial companies were unfairly punished for the problems of other financial companies. Fortunately, as clarified SFAS 157 allows financial companies to avoid undue asset write-offs and capital destruction going forward. Banks on the whole are in much better shape these days than a few months ago largely as a result of various government programs, but there is no doubt this improvement is also partly attributable to the recent clarifications on SFAS 157.

Investing in Bonds vs. Bond Mutual Funds

By Deborah Lee
Senior Financial Advisor

Bonds are fixed-income investment vehicles, which include municipal bonds, treasuries, corporate bonds and government agency offerings. Buying individual bonds allows the investor to pick bonds that fit his or her investing parameters, generate regular and predictable income and get a return of principal at maturity. Bond funds are mutual funds that invest entirely in bonds. Like all mutual funds, bond funds give you needed diversification even if you don't have a big portfolio. The value of the fund is based on the net asset value on the day that you want to sell. Fund returns fluctuate.

There are many factors you should consider before deciding whether buying individual bonds or bond funds is right for you. Here's a chart comparing some of the major differences between individual bonds versus bond funds.

	Individual Bonds	**Bond Mutual Funds**
Interest Payments	**Fixed amount usually payable semi-annually**	**Payments vary and made monthly**
Diversification	**Only through multiple bond holdings**	**Diversified by nature**
Investment Size	**Usually $1,000 per bond but varies depending on type**	**As low as $1,000 initial investment, $100 for subsequent purchases**
Maturity	**Under 1 month to 30 years available**	**No set maturity**
Management	**Client manages himself or uses investment manager**	**Managed by fund managers**
Risk	**Depends on the bond**	**Depends on the underlying bonds owned by fund**
Fees	**Low fees especially if use discount brokers**	**Varies**
Value Predictability	**Absent default, will get principal back if held to maturity**	**Net asset value realized upon fund sale not predictable**
Liquidity	**Depends on market conditions and type and size of bond**	**Can sell bond fund any time**
Tax Control	**Can control timing of capital gain/loss realization**	**Timing of capital gain/loss realization decided by fund manager**