

# It's All About Resource Allocation

**Alan Zimmermann**



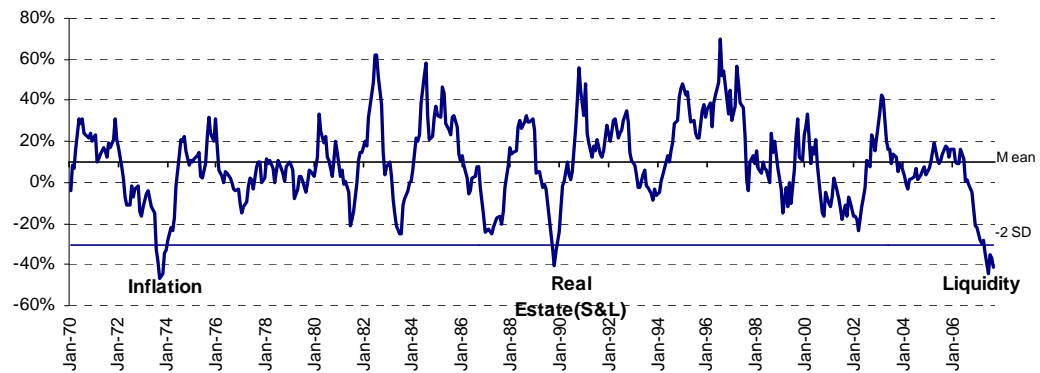
Fox-Pitt Kelton  
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November, 2008

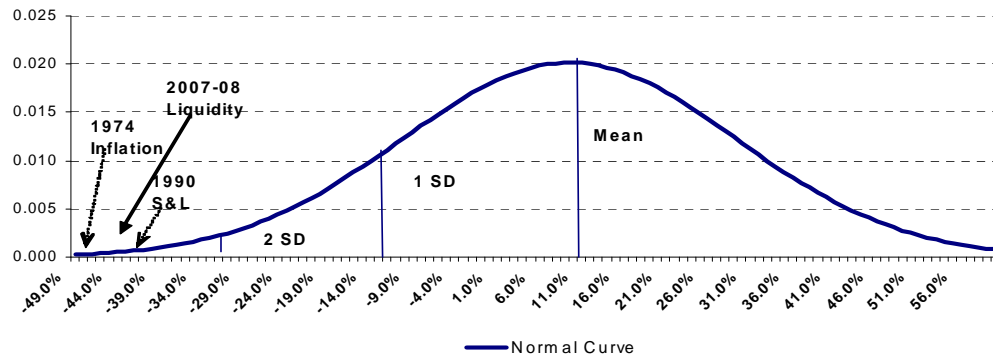
# The 2007-2008 Crisis in Perspective

The industry and the markets have been here before.

**S&P 500 Financial Index  
Year-to-year % Changes**



**S&P500 Financial Index: Normal Curve**



# Capital Markets and Accounting at a Critical Crossroad

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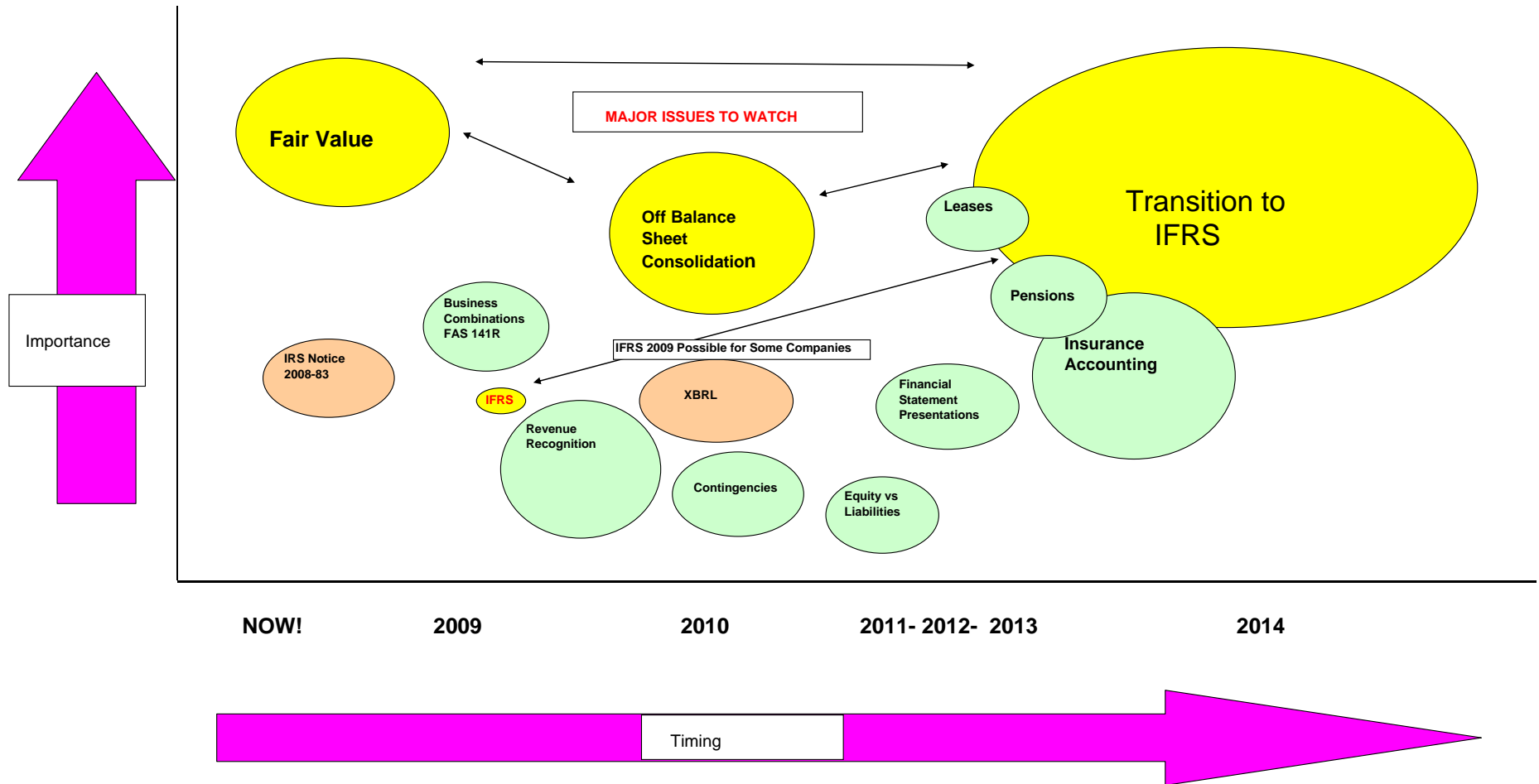
Slide on following page is from a speech to a group of portfolio managers.

The message is :

There are three critical accounting issues in the world today. These must be dealt with.

- **Capital markets are transitioning from a Banking/Financial/Liquidity Crisis to a Global Recession.**
  
- **Governments have intervened in the capital markets in an extreme manner.**
  
- **Accounting is at the center of the storm.**
  
- **Users Need Standards Setters to be Focused on the Most Critical Issues**
  - Other issues need to be set aside if time is not available.**
  - Where does Insurance accounting fit in?**
  
- **Its All About Resource Allocation!**

# Three Major Issues Dominate the Accounting Horizon



# The Fair Value Stage has been Set: The Roles have been Assigned

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Fair Value will remain the most visible and contentious issue.

- **Reporting companies** (and their trade associations) generally are opposed in varying degrees.
- **Users (not all):** Generally support Fair Value.
  - Investors have already said what they think about bank asset values.
  - Europeans more strident
- For **politicians** its just theater.
- The **general public** has no clue about what the debate is about.

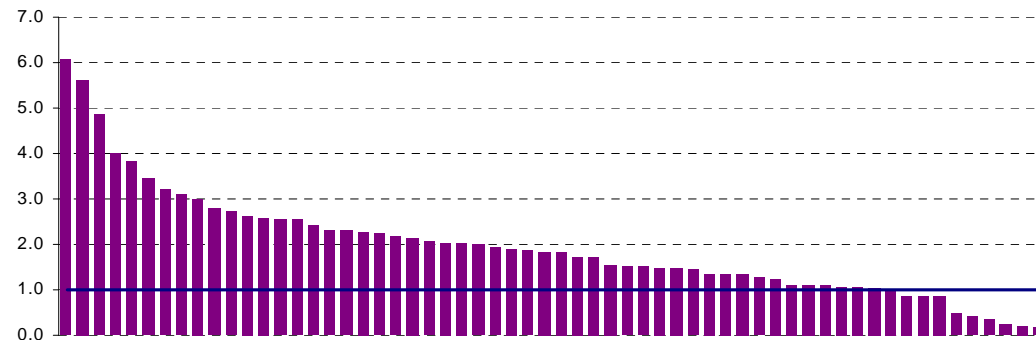
# Investors Have Already Weighed In

27 of the 60 banks we follow are valued below book. 9 banks sell below tangible book.

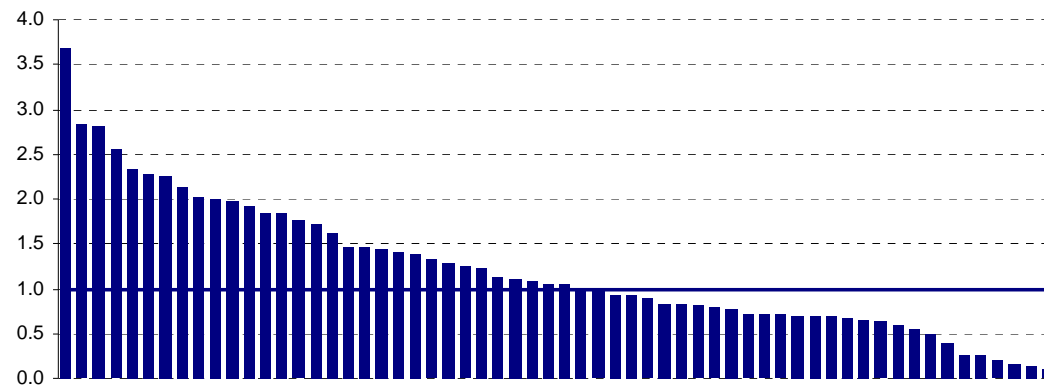
Investors impute their own idea of fair value.

Bank acquisitions generally confirm fair value below tangible book.

**FPK US Banks Universe**  
**Price-to-Tangible-Book Ratio**



**FPK US Bank Universe**  
**Price-to-Book Ratio**



# Fair Value Only Applies to Bank Securities

Bank loans are generally not carried at fair value.

This point seems lost on many observers.

June 30, 2008

Assets Carried at Fair Value  
as % of

	<u>Assets</u>	<u>Equity</u>
Capital markets bank	33%	431%
All other banks	<u>17%</u>	<u>177%</u>
Total FPK universe	28%	336%

<u>Fair Value Assets by</u>	<u>Amount</u> <u>(\$ Bil.)</u>	<u>Percent</u>
Level 1	498	22%
Level 2	1,468	63%
Level 3	<u>346</u>	<u>15%</u>
Total	2,313	100%
Total assets	8,262	
Total equity	687	

Expect Level 3 assets will rise in 3Q

FPKCCW bank coverage universe.

Watching 3Q Results for US Banks. To date doesn't appear clarification had much impact.

# Why European Critics are Screaming More than Americans

European banks own much more securities than in US.

## Securities as a % of Assets

	Bank A	Bank B	Bank C
Securities at fair value through P&L	473	461	1,003
Securities available for sale	86	168	121
Subtotal	559	629	1,124
Total assets	1,075	1,464	1,517
As % assets	52%	43%	74%

## Securities as % of assets US

Large cap banks	21%
Mid cap banks	17%
Small cap banks	<u>19%</u>
Total	19%

Company Reports: June 30, 2008



# Political Theater on Both Sides of the Atlantic

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But, the SEC already has the legal authority to establish accounting rules; they don't need this law.

Politicians are not bound by the need for intellectual consistency.

## From H.R. 1424: Sec. 132 Authority to Suspend Mark-to-Market Accounting

➤ The Securities and Exchange Commission shall have the authority under the securities laws...to suspend the application of Statement Number 157 of the Financial Accounting Standards Board...if the Commission determines that it is necessary or appropriate in the public interest and is consistent with the protection of investors

## From Council of the European Union (ECOFIN) statement October 7, 2008

➤ In this respect, financial institutions are continually making efforts to improve disclosure of their exposure to risks.

➤ On asset valuation, revised standards are urgently awaited from the International Accounting Standards Board; otherwise, persistent concern about the accounting treatment of assets will continue to undermine investor confidence.

# More Assets on Balance Sheets Will Present Analytical Challenges

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Challenges are greater for investors and regulators than for standards setters.

- Revisions to FAS 140 and FIN 46R will result in more assets on corporate balance sheets.
- Key for financial statement users is to recognize that balance sheet assets have varying levels of risk exposures.
  
- **Investors**—will be challenged not just to calculate traditional ratios.
  - ☐ Don't freak out when you see the numbers.
  
- **Regulators**—must have different risk weightings for various levels of exposure.

# Transitioning the US to IFRS is the Ultimate Goal

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This will greatly benefit all involved in the capital markets.

- The **SEC** established the transition process in August
- But there's no Roadmap yet.
  - ❑ What's the message?
- **US companies and auditors** will have difficulty dealing with the lack of specifics.
  - ❑ Part of this is tradition; part is liability laws.
- For **investors** the transition will be easy
  - ❑ Many third parties will be willing to assist.
  - ❑ Reporting companies will have vested interest in assuring that investors understand the system.
- **Bottom line: If you can understand US GAAP you can understand IFRS.**

# US Reporting Companies are Not Used to Using Judgment

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Insurers request an elaboration of the clarification.

[From October 23, 2008: Letter to SEC Chairman Cox from trade associations including ACLI, Property Casualty Insurers Association of America and the American Insurance Association](#)

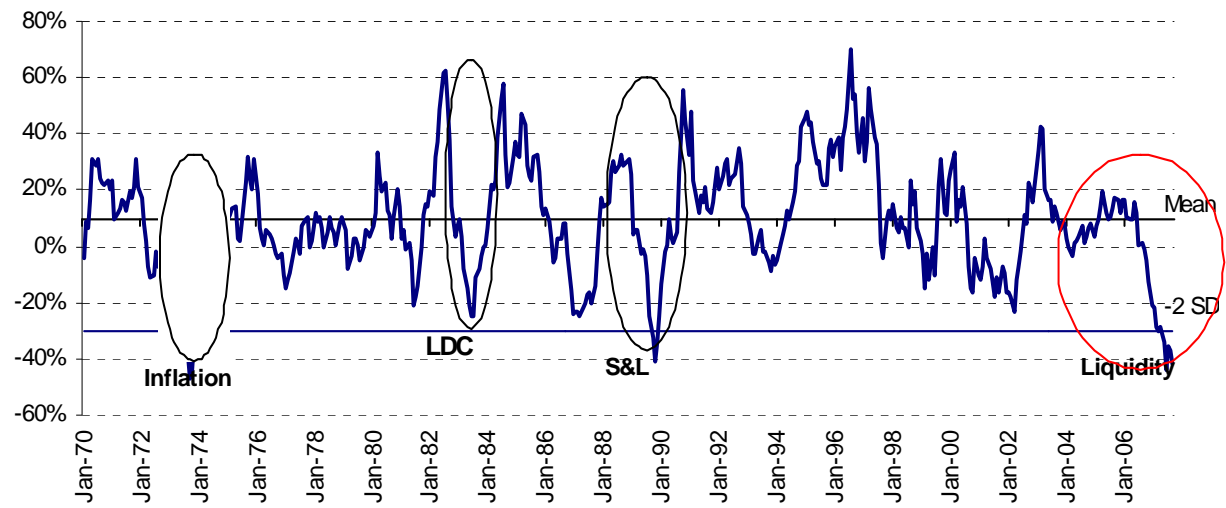
➤ As the ultimate arbiter, for publicly held companies, of accounting standards in the United States, we would respectfully request that the SEC formally elaborate on the use of judgment in the application of FAS 157. This elaboration, by the SEC, should include principles-based guidance for the transparent disclosures needed by investors when judgment is exercised. The elaboration will provide the clarity needed by management to appropriately value assets in inactive markets, and give investors the transparent information needed to make informed decisions.

# The Past is Usually Prologue!

Will something like the 2007-2008 financial crisis happen again? Probably!

Will the stocks recover as they have in the past? Eventually!

### S&P 500 Financials Index - Annual Changes



Source: FactSet, FPKCCW