



Understanding the Accounting of Realized and Unrealized Losses At Corporate Credit Unions

The recent downturn in the U.S. economy has affected virtually all financial institutions, including credit unions. What started as concern over a bursting housing bubble quickly enveloped and consumed some of the world's largest and most recognized names in the banking and investment world. Companies like Bear Stearns, Lehman Brothers, Citibank, AIG, Merrill Lynch and Goldman Sachs either didn't survive, are still struggling, or have become vastly different institutions.

But in all the economic bad news, there are still sectors that are not only surviving, but thriving. Credit unions continue to be a bright spot, both to the economy as a whole, and especially to their members. While not totally unaffected, credit unions remain highly capitalized and are making loans in record numbers to their members – members who in many cases are unable to secure a loan at a bank. As highly regulated, not-for-profit financial cooperatives, credit unions have always focused on doing what's right for their members, and not on making risky investments. Corporate credit unions (Corporates) have followed that same philosophy.

Corporates

Corporates are wholesale financial service providers to the credit union system. Wholly owned, capitalized and managed by a volunteer board of directors made up of retail credit union management, corporates have evolved from providing liquidity (funding) to their members, to offering an array of other products and services. Corporates offer investment, liquidity, and settlement services as well as many payment-processing services (check and image processing, ACH, wire transfers, bill pay, and ATM services), deposit/cash management services, business services, and many other products and services that are vital to the credit union industry. In fact, Corporates provide more than 90% of the nation's credit unions with one or more of these services.

Securities

But there is a major difference between Corporates and retail credit unions. To serve and add value to their member credit unions, Corporates work within the world of high finance. As part of this process, Corporates regularly invest in highly rated marketable securities. Investing in a security is similar to a retail credit union making an auto or home loan, in that there is some sort of collateral

backing the loan, or in this case, the investment. The biggest difference between an auto or home loan at a credit union and a security purchased by a Corporate is that instead of just one piece of collateral, such as a car, a security might have as collateral thousands of car loans, or student loans, or mortgages, all wrapped up into one investment. And just like a car loan, payments of principal and interest are sent regularly to the Corporate, usually monthly, to pay back the investment in the security. Furthermore, just like at a retail credit union making a car loan, the Corporate earns income from the investment in that security, used to fund and provide other services for its credit union members, which is the mission of each Corporate.

Ratings and Ratings Agencies

Corporates literally have billions of dollars invested at any one time on behalf of their member credit unions. In fact, currently Corporates hold, in total, more than \$90 billion dollars of investments. The good news is that Corporates are highly regulated by the National Credit Union Administration (NCUA) and are only permitted to invest in the highest-rated securities available. That means that every security corporates purchase has to meet very stringent criteria – much like an applicant applying for a car loan that must have a credit score over a certain number. But unlike credit scores, securities are actually rated by independent firms, called ratings agencies. The three most prominent ratings agencies are Standard and Poor's, Moody's and Fitch. These ratings agencies look at each security, the collateral behind it, the history of the issuer, etc., and then give the security a rating. Corporates, by law, are only permitted to invest in those securities that are rated at or near the top of the ratings scale. This helps to ensure that our members' funds are well invested and shielded from potential losses.

Losses on Securities

There are many measures to ensure the funds of member credit unions are shielded against potential losses, including: policies determined by boards of directors; close monitoring by the government regulatory agency - the NCUA; and, close scrutiny of investments by independent organizations such as ratings agencies, and internal and external auditing firms. However, Corporates, and some retail credit unions, are beginning to announce losses on their investment portfolios. These losses stem from several factors, including the continued downturn in the housing market, as projected losses on the mortgages that collateralize those securities become more likely to occur, either now or in the future. Just like on a car loan at a retail credit union, once the borrower stops making the payments, the credit union has to begin writing the loss of principal off the books. This is similar, but not exactly, to what is going on at Corporates.

Fair Value Accounting

At a retail credit union, when there are potential losses, the credit union records a provision for loan losses (Loan Loss Reserve) on the income statement, and as actual losses are realized over time, the reserve is increased or decreased,

depending on whether true losses were higher or lower than estimated. But with securities, potential losses are treated differently, using an accounting methodology called fair value accounting. Before talking about how fair value accounting is affecting Corporates and some retail credit unions, let's take a closer look at how fair value accounting works in general.

In today's business world, transparent accounting has become both a necessity, and a requirement. Business failures and fraudulent accounting practices from companies like Enron, WorldCom, and Tyco have forced accounting changes that can leave even the most seasoned accountant confused. Much of the confusion has centered on what the Federal Accounting Standards Board (FASB) calls "fair value" accounting rules. (*FASB is the United States designated organization for establishing standards for financial accounting and reporting.*) FASB designed these rules to make it easier for investors to understand the value of a company's assets and provide consistent reporting among comparable firms.

A basic tenet of fair value accounting is that securities that are available to be sold on the open market (this is the case for most securities owned by Corporates) must be "valued" each month. To determine the "value" of these securities, organizations are instructed to use the "market" value of the security, meaning how much the security would sell for if sold that day. For several years, this method proved consistent in providing valid market values for the securities. However, the deep and sustained economic problems that the global markets are experiencing have pushed down the "market" value of most securities considerably, no matter if the underlying collateral remains solid. The effect is that even if Corporates are receiving payments of principal and interest as expected, fair value accounting says the Corporates (and all investors in asset backed securities) need to account for losses on their financial statements. These losses can be what are called realized or unrealized.

Unrealized Losses

Losses on securities are considered unrealized if the securities are considered "temporarily impaired." This means that in all likelihood, the security is performing as expected, but has had a decline in market value due to a lack of buyers who have the liquidity (funds), or the desire to purchase it if sold. For Corporates, fair value accounting requires that they indicate the difference in the book value of the security (the price paid for the security) and the market value of the security (the price if sold that day) on their balance sheets, under the designation, "Accumulated Other Comprehensive Income/Loss" or AOCI. The good news is that as market values rebound on the securities, the unrealized losses are reversed off the balance sheet.

Realized Losses

Losses on securities become "realized" when it is determined the securities will not pay back some portion of the principal. Note that even when realized losses

occur, it does not necessarily mean that the securities have been sold and could, in fact, regain part of the realized loss as securities reach maturity. There are two designations of realized losses, “other than temporary impairment” (OTTI), and “permanent”. Losses are considered “permanent” when it becomes evident that the issuer of the security will be unable to pay back the remaining principal owed to the investor. This loss is fairly straightforward and is recorded as a reduction to earnings on the income statement.

The other designation for realized losses is OTTI. This is the most complex to explain, and is likely to be experienced by a few of the 27 Corporates that make up the Corporate Network.

If an organization has insufficient income to absorb realized losses, then a reduction to capital is necessary to cover the loss. In the case of Corporates, that would be reserves and undivided earnings (RUDE) first, followed by Paid-in-Capital as applicable, and then Membership Capital.

Because OTTI is complex and so important to understand, attached are some Frequently Asked Questions (FAQs) specifically related to OTTI and fair value accounting. These questions and answers should help explain how OTTI is accounted for by affected Corporates due to fair value accounting rules. Additionally, the FAQs will further explain some of the other accounting terms discussed earlier and help readers better understand Corporates’ current position and their ability to continue to serve retail credit unions and their members.

However, while these FAQs should go a long way toward explaining potential losses and their accounting treatments, there’s no substitute for talking one-on-one with your Corporate. The individuals you deal with on a regular basis will be happy to explain anything about these issues, their investment holdings and their financials. You are always encouraged to call your corporate for more information.

FAQs on OTTI

1. What is OTTI?

OTTI stands for “Other Than Temporary Impairment”. It is an accounting term that is intended to reflect write-downs of assets (typically securities in the case of Corporates) on the balance sheet, due to assumptions about the probability of collecting the full 100% of the value of that security, either today or possibly even years into the future.

2. What is “Impairment”?

An “Impairment” exists when either the book value of a security (the amount paid for the security less any principal payments received) or the sum of the security’s estimated future cash flows, exceeds its “fair value” which represents its current market value. In other words, impairment occurs when the expected sale price of the security on the open market is less than the value of the security if held to maturity.

There are three types of “impairment”, and each has its own accounting treatment. They are:

- A. Temporary Impairment – when a security loses value due to factors related to market conditions. For example, if a \$100 security was purchased with an interest rate of 4% and then interest rates increase, the value of that security would decrease. This is due to the fact that investors who buy new \$100 securities will receive a better yield thanks to the increased rate, thus making securities issued at the 4% rate less attractive. Another example is when the market for buying or selling securities becomes frozen. When this happens, the market value of securities can decline for no other reason than no one is buying them at the present time – this is the situation today for many institutions, including some corporate credit unions.

Accounting Treatment: Temporary impairments are considered, for accounting purposes, as “Unrealized Losses”. The accounting treatment for unrealized losses is to record an entry on the equity portion of the balance sheet under Accumulated Other Comprehensive Income (Loss), or AOCI. AOCI is a placeholder of sorts until one of three events occur: the “temporary” impairment is reversed because market changes cause the value to go up; the security is determined to be “other than temporarily impaired”; or, it becomes “permanently impaired”. AOCI exists to inform the reader of the financial statement of the theoretical value of the investments if they were sold at that point in time.

- B. Permanent Impairment – when an issuer is unable to pay 100% of a security’s principal back to the investor. For example, if a security issuer, such as a company or municipality defaults on its debt, decreasing or eliminating a security’s value.

Accounting Treatment: The accounting treatment for permanent impairment is to write down the security’s book value (the amount paid for the security) on the organization’s income statement.

- C. Other than Temporary Impairment (OTTI) – when it becomes likely that investors will be unable to collect the FULL 100% value of a security. For example, an issuer of a security collateralized by mortgages is unable to make full principal and interest payments to investors due to foreclosures of homes.

Accounting Treatment: The accounting treatment for securities that have OTTI is to write down the value of the securities to their “fair value” (the theoretical value of the security if sold at that point in time on the open market). However, this may not accurately reflect the true economic value of the security. (*For additional information on OTTI accounting, see question #5 on FAS 115.*)

3. How is OTTI determined?

There are many sources of accounting literature that reference impairments and OTTI, but ultimately it is a judgment call. Low market prices or adverse ratings actions may *indicate* impairment, but whether you actually suffer a loss depends on if you get your money back—or not. While Corporates set standardized processes to identify and project potential impairments (processes that are reviewed regularly by their external auditors) they also continue to work with their auditors and other independent third-party valuation firms to best determine potential OTTI on their portfolios.

4. Is OTTI considered to be a “realized” loss?

In the sense that they are write-downs -- not sales -- of securities, they are not *realized*. However, they are *recognized* in the income statement in the same way as a realized loss stemming from a sale. But with OTTI charges, there may be an opportunity to recoup losses, whereas once a security is sold, the accounting result is final.

5. What is FAS 115?

The Financial Accounting Standards Board (FASB) determines the accepted accounting standards for American companies. There is a specific guideline, (Financial Accounting Standard (FAS) 115), that deals with accounting for OTTI.

The goal behind FAS 115 was to provide investors with accurate information about a company's true value at a specific point in time based on existing market values, or "fair values", of its assets, instead of book values (the amount paid for a security less any principal payments) in an orderly and active market. However, even perfectly performing securities can become devalued when credit markets freeze and markets become inactive as a result of economic or other conditions.

Put another way, FAS 115 records a security's *accounting* loss (the difference between "book value" and "fair value"). But in an illiquid market, such as today's, FAS 115 may not accurately reflect a security's *economic* or cash loss (the principal you do not expect to receive).

The Securities and Exchange Commission (SEC) and the FASB have recently held several roundtable meetings and are seeking input for addressing the disparities of FAS 115 in reporting true economic losses on assets that are experiencing OTTI versus reporting losses that, while they conform to FAS 115, may actually inflate the reporting of true losses the company might experience.

6. If there are no changes to FAS 115 from the FASB, how will Corporates account for OTTI and what impact will it have on their balance sheets?

For the Corporates that hold asset-backed securities in their portfolios, they will be working with regulators, auditors and independent third-party valuation firms to best determine "fair values" of their securities, as well as any potential losses of principal and interest. If it is determined that any of their securities are likely to experience losses, then those Corporates will write-down those securities to their current "fair value" (the value of that security if sold on the open market today). This write-down will appear on the Corporate's income statement as a loss.

Over time, if the securities that are written down continue to perform and Corporates receive principal payments on the securities that exceed the value to which the security was written down, those payments will show as non-interest income on the income statement and be additive to the corporate's RUDE.

7. Are Corporates experiencing losses on securities because of risky investment strategies, such as buying subprime mortgages?

Corporates, by regulation, may only purchase highly rated investment vehicles. Looking back, it is clear that underwriting of some mortgages was aggressive and many people were granted mortgages they could not afford. Additionally, ratings agencies used flawed logic in assigning their highest ratings to some of these securities. These factors influenced the actual quality of some of the highly rated securities that Corporates purchased in recent years. However, the majority of losses are the result of the frozen credit market.

Back as far as the summer of 2007, losses began occurring on many mortgage-backed securities – even those rated AAA. Once this began, prices on these and other types of securities, even well-performing securities, such as government-backed student loans, auto loans or credit card receivables, began to lose market value as financial institutions stopped buying them and began to focus on hoarding cash to cover any potential losses in their mortgage-backed portfolios. This created an illiquid market where the trading of securities became frozen and market values of virtually all securities, even those backed by the federal government, lost a substantial portion of their market value. In fact, much of the unrealized losses Corporates are reporting are on both mortgage-backed and non-mortgage-backed securities that have lost value solely because of the frozen credit markets, and not because of poor performance of the securities themselves.

8. What types of OTTI charges are expected by the Corporate Network?

The OTTI charges that have been recorded by some Corporates to-date reflect all of those securities for which their internal analytics, and/or the work of outside auditors and independent valuation firms, has indicated a high probability of future loss of principal.

Corporates will continue to closely monitor the performance of their portfolios on an ongoing basis, and will make such future adjustments as might be necessary.

That being said, it is expected that the Corporate Network will see minimal realized losses on their securities portfolios compared to the unrealized losses on temporarily impaired securities that are currently being reported as Accumulated Other Comprehensive Income (Loss), AOCI. This is due to the fact that these securities continue to perform and cash flow as expected and Corporates continue to have the intent and the ability to hold their securities to maturity, as they have the liquidity to continue to fund their members' needs without having to sell these securities at "fire-sale" prices. Additionally, much of the losses attributed to OTTI are expected to reverse over time as the securities continue to pay principal above the current market value of these securities.

9. Have Corporates really lost billions?

No. The vast majority of what has been reported represents accounting treatment that does not accurately reflect the true value of Corporates' investments, or what is expected to be recouped over time.

10. How are Corporates performing during this time of instability in the financial markets?

Corporate credit unions continue to show solid financial performance despite the challenging financial markets.

Corporate credit unions in aggregate hold total capital of more than \$6 billion and year-to-date earnings were a healthy \$121 million (\$107.2 million after distribution of paid-in-capital dividends) through September (excluding U.S. Central FCU). When U.S. Central is included, the Corporate Network has more than \$8.6 billion in total capital and September year-to-date earnings were \$166.9 million (\$144.2 million after distribution of paid-in-capital dividends).

In addition to strong earnings and capital growth, corporates continue to serve their members' investment, liquidity, and payment system needs.

11. Should retail credit unions continue to have confidence in the Corporate Network?

Yes. The Corporate Network continues to be a strong source of investments, liquidity and other services to the natural-person credit union community.

Virtually all sectors of the financial services industry are experiencing challenges due to present market conditions. Corporate credit union members, regulators and auditors continue to have confidence in corporates' ability to absorb any potential losses, thanks to the Corporate Network's adequate capital position and continued strong earnings.