Next Bubble to Burst Is Banks' Big Loan Values:

Commentary by Jonathan Weil

Aug. 13 (Bloomberg) -- It's amazing what a little sunshine can accomplish.

Check out the footnotes to Regions Financial Corp.'s latest quarterly report, and you'll see a remarkable disclosure. There, in an easy-to-read chart, the company divulged that the loans on its books as of June 30 were worth $22.8 billion less than what its balance sheet said. The Birmingham, Alabama-based bank's shareholder equity, by comparison, was just $18.7 billion.

So, if it weren't for the inflated loan values, Regions' equity would be less than zero. Meanwhile, the government continues to classify Regions as "well capitalized."

While disclosures of this sort aren't new, their frequency is. This summer's round of interim financial reports marked the first time U.S. companies had to publish the fair market values of all their financial instruments on a quarterly basis. Before, such disclosures had been required only annually under the Financial Accounting Standards Board's rules.

The timing of the revelations is uncanny. Last month, in a move that has the banking lobbyfuming, the FASB said it would proceed with a plan to expand the use of fair-value accounting for financial instruments. In short, all financial assets and most financial liabilities would have to be recorded at market values on the balance sheet each quarter, although not all fluctuations in their values would count in net income. A formal proposal could be released by year's end.

Recognizing Loan Losses

The biggest change would be to the treatment of loans. The FASB's currentrules let lenders carry most of the loans on their books at historical cost, by labeling them as held-to- maturity or held-for-investment. Generally, this means loan losses get recognized only when management deems them probable, which may be long after they are foreseeable. Using fair-value accounting would speed up the recognition of loan losses, resulting in lower earnings and reduced book values.

While Regions may be an extreme example of inflated loan values, it's not unique.Bank of America Corp. said its loans as of June 30 were worth $64.4 billion less than its balance sheet said. The difference represented 58 percent of the company's Tier 1 common equity, a measure of capital used by regulators that excludes preferred stock and many intangible assets, such as goodwill accumulated through acquisitions of other companies.

Wells Fargo & Co. said the fair value of its loans was $34.3 billion less than their book value as of June 30. The bank's Tier 1 common equity, by comparison, was $47.1 billion.

Widening Gaps

The disparities in those banks' loan values grew as the year progressed. Bank of America said the fair-value gap in its loans was $44.6 billion as of Dec. 31. Wells Fargo's was just $14.2 billion at the end of 2008, less than half what it was six months later. At Regions, it had been $13.2 billion.

Other lenders with large divergences in their loan values includedSunTrust Banks Inc. It showed a $13.6 billion gap as of June 30, which exceeded its $11.1 billion of Tier 1 common equity. KeyCorp said its loans were worth $8.6 billion less than their book value; its Tier 1 common was just $7.1 billion.

When a loan's market value falls, it might be that the lender would charge higher borrowing costs for the same loan today. It also could be that outsiders perceive a greater chance of default than management is assuming. Perhaps the underlying collateral has collapsed in value, even if the borrower hasn't missed a payment.

The trend in banks' loan values is not uniform. Twelve of the 24 companies in theKBW Bank Index, including Citigroup Inc., said their loans' fair values were within 1 percent of their carrying amounts, more or less. Citigroup said the fair value of its loans was $601.3 billion, just $1.3 billion less than their book value. The gap had been $18.2 billion at the end of 2008.

Covering Liabilities

History provides some lessons here. A common problem at savings-and-loans that failed during the 1980s was that they relied on short-term funding at market rates to finance their operations, which consisted mainly of issuing long-term, fixed- rate mortgages. When rates rose sharply, the thrifts fell in a trap where their assets weren't generating sufficient returns to cover their liabilities.

The accounting rules also left open the opportunity for gains-trading, whereby companies post profits by selling their winners and keeping losers on the books at their old, inflated values. Had the thrifts been marking loans to market values on their balance sheets, their troubles would have been clearer to outsiders much sooner. (The FASB didn't require annual fair- value footnote disclosures until 1993.)

Arbitrary Accounting

If nothing else, today's fair-value gaps highlight the arbitrariness of book values and regulatory capital. Banks already have the option to carry loans at fair value under the accounting rules. For the vast majority of loans, most banks elect not to, on the grounds that they intend to keep them until maturity and hope the cash rolls in.

Consequently, the difference between being well capitalized and woefully undercapitalized may come down to nothing more than some highly paid chief executive's state of mind.

Fair-value estimates in the short-term can be a poor indicator of an asset's eventual worth, especially when markets aren't functioning smoothly. The problem with relying on management's intentions is that they may be even less reliable.

At least now we're getting some real numbers, even if you have to dig through the footnotes to get them.

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