

# **ACCOUNTING FOR COMMERCIAL LOAN COMMITMENTS**

**By**

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## **Introduction**

This report presents our analysis and opinion concerning the proper treatment of commercial loan commitments in the financial statements of the issuing entities. Loan commitments are contractual promises made by financial institutions to lend money to borrowers upon request over a certain period of time. These commitments, also known as standby loan commitments, exceeded in aggregate at the end of 2003 \$600 billion at the three major providers of these facilities<sup>1</sup>. Given the substantial size and the increasing economic role played by loan commitments, the efficient functioning of the real and financial markets requires both a proper accounting for and a revealing public disclosure of the risks and rewards associated with these financial instruments. Investors and policymakers must obtain the necessary information to assess the full scope of the risks assumed by those who issue loan commitments, as well as the extent to which the rewards (loan commitment fees) are commensurate with these risks.<sup>2</sup> A fair and accurate presentation of loan commitments in financial statements will also be useful to board members of issuers and thereby improve the governance of these important financial institutions.

We open this report (Section I) with a brief survey of the current disclosure requirements concerning loan commitments, followed by an examination of the actual disclosure of commercial loan commitments by the three major providers of these financial instruments: J.P. Morgan Chase, Citigroup, and Bank of America. It is evident from this examination that the

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<sup>1</sup> Ergunor (“Theories of Bank Loan Commitments,” Economic Review, Federal Reserve Bank of Cleveland, 3<sup>rd</sup> Quarter 2001, p.2) notes: “ A recent Federal Reserve survey shows that 79 percent of all commercial industrial lending is made under commitment contracts. Moreover, as of March 2001, outstanding (unused) loan commitments of U.S. corporations exceeded \$1.6 trillion, up from \$743 billion in 1990.”

<sup>2</sup> Because of deposit insurance, commercial banks’ bankruptcy risk may be borne in part by the public. Furthermore, the main providers of commercial loan commitments are very large banks for whom the Federal Deposit Insurance Company Improvement Act of 1991’s prohibition of a “too big to fail” policy by bank regulators may not apply due to the “systemic risk exception.”

current information provided by the primary loan commitment issuers in their financial reports is inconsistent both across providers and over time as well as deficient with respect to key economic aspects of these commitments, notably their fair values.

This deficient disclosure raises the question whether current generally accepted accounting principles (GAAP) provide for a substantially improved disclosure of loan commitments. We address this question in Section II of the report by identifying two GAAP pronouncements—FASB Interpretation No. 45 (FIN 45), and Emerging Issues Task Force No. 00-21 (EITF 00-21)—which, in our opinion and under certain circumstances, call for loan commitments to be recorded upon initiation at fair value, as well as for the liability inherent in the loan commitment to be disclosed in the financial statement. Since loan commitments were exempted from FIN 45 presumably on the basis of material adverse change (MAC) clauses (the presence in some loan commitment agreements of various conditions aimed at restricting the liability of the issuer to extend a loan), we provide a discussion of these clauses, and conclude that in many cases they do not invalidate the liability inherent in loan commitments. We, therefore, believe that loan commitments, even with MAC clauses, should not be exempted from FIN 45. Furthermore, it is our opinion that when loan commitments are provided in a bundle of services, their accounting and disclosure should follow EITF 00-21; namely, fair-value recording of the commitment upon initiation and subsequent financial statement disclosure of the liability.

Having concluded that loan commitments should be recorded and presented at fair value, we turn in Section III to examine the issues of fair value implementation. We argue in this section that the fast-developing related instruments in the risk and credit markets—bonds, credit default swaps, and the secondary market for loan commitments—generally provide adequate

information and support for a reliable fair value of loan commitments, particularly for large, investment-grade borrowers.

We, therefore conclude that commercial loan commitments should both be recorded upon initiation at fair value and presented in financial reports as a liability.

## **I. Current Disclosure of Commercial Loan Commitments**

Under current generally accepted accounting principles (GAAP), the liability inherent in a loan commitment (LC) is typically not “recognized” in financial reports (i.e., has no income statement or balance sheet impact) at origination. The recognition of certain elements of LCs in financial statements is required when: (a) fees are received over time for a LC (in this case, the fees initially are deferred as a liability and credited in entirety to income when the commitment is terminated or over the life of the loan if the LC is drawn), or (b) losses from LCs become probable and capable of reliable estimation and therefore have to be included in the allowance for credit losses or another reserve. The fair value of LCs should, if practicable to estimate, be clearly disclosed in footnotes to the financial reports under SFAS 107, elaborating on the methods and assumptions underlying the fair values.<sup>3,4</sup> If these fair values are not practicable to

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<sup>3</sup> In his March 4, 2003 testimony before the House Subcommittee on Commerce, Trade and Consumer Protection, Robert Herz, Chairman of the Financial Accounting Standards Board (FASB), said: “Loan commitments, of course, are a form of financial instrument and one of many... We require supplementary footnote disclosure relating to the fair value of all financial instruments, including loan commitments...”

In a March 24, 2003 letter to the Subcommittee Chairman, Representative Cliff Stearns, FASB Chairman, Robert Herz states: “ In addition, information about loan commitments, including their fair value (and the fair value of loans and other financial assets and liabilities) and the methods and assumptions used to estimate the fair value, is required to be disclosed in the notes to enterprises’ financial statements.” Footnote 6 of the letter, related to the preceding sentence says: “FASB Statement No. 107 *Disclosures about Fair Value of Financial Instruments* (1992), Par. 10.

estimate, then information pertinent to the commitments (e.g., amounts, maturities, and credit ratings of borrowers) as well as the reasons underlying the impracticality of fair value estimation should be disclosed.

Thus, while current GAAP does not seem to require the fair-value recognition of loan commitments at origination, there are certain clearly specified disclosure requirements concerning those commitments. We will now consider the extent to which the three major providers of commercial LCs—J.P. Morgan Chase & Co., Citigroup Inc., and Bank of America Corp.—presented required and otherwise relevant LC information in their annual financial reports for the past three years (2001–2003). The discussion of the banks’ disclosures is classified into three categories: SFAS 107 disclosures of fair values or information useful for the estimation of fair values, disclosures of the level and changes in loan loss allowances, and other LC-related disclosures. We first describe these disclosures in detail and then assess their adequacy.

(i) **SFAS 107-Fair Value Disclosures:**

**Citigroup**

The 2003 annual report provides a table (page 146) that presents a classification of LC and gives the totals of “Commercial and other consumer loan commitments” as \$210.8 and \$214.2 billion, for the end of 2003 and 2002, respectively.<sup>5</sup> Citigroup states that approximately 60% of these LCs have

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<sup>4</sup> In addition, as mentioned in Mr. Herz’s March 28, 2003 letter to Chairman Stearns (answer to Question 3): “information about all significant concentrations of credit risks arising from all financial instruments, including loan commitments [has to be disclosed].” (FASB Statement No. 133, Par.531 (d)).

It should be noted that loan commitments that relate to the origination of mortgage loans that are held for resale should be accounted for as derivatives under SFAS 133 (Derivative Implementation Group Issue C13, March 26, 2003 and SFAS 149 par. 3). Other loan commitments are not considered derivative instruments according to SFAS 149 (par. 7e).

<sup>5</sup> The discussion section of the 2003 report (page 78) includes a table in which “Unfunded commitments” as of 12/31/03 are reported as \$218 billion.

maturities of less than one year and that the “majority of unused commitments are contingent upon customers maintaining specific credit standards.” The fair-value footnote of the 2003 report (No. 27) does not appear to mention LCs.

The 2002 report also provides a table (page 125) of loan commitments by type, and it states the totals of “Commercial and other...commitments” as \$214.2 and \$210.9 billion, at the end of 2002 and 2001, respectively. We did not find information on the fair value of LCs. The 2001 and 2000 balances of “Commercial and other consumer loan commitments” are given as \$210.9 and \$197.4 billion, respectively. Again, without fair value data.

### **Bank of America**

The 2003 annual report states that loan commitments totaled \$211.8 and \$212.7 billion at the end of 2003 and 2002, respectively. It further states that “Certain of these commitments have adverse change clauses that help to protect the Corporation against deterioration in the borrowers’ ability to pay.” (These clauses are elaborated on in Section II A.) Yet, no information about how many of the commitments have such clauses is provided. We did not see specific information on fair value of LC in the report. The information provided about loan commitments is similar in the preceding 2002 and 2001 annual reports; namely, no fair-value information is provided, just the total balance of nominal commitments.<sup>6</sup>

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<sup>6</sup> The 2001 report includes a table of LCs classified by maturities.

**J.P. Morgan Chase & Co.**

J.P. Morgan Chase provides in its 2003 report estimates of the fair values of its “commercial commitments to extend credit, based on the cost of credit derivatives” (emphasis ours—the relevance of this emphasis is clarified in Section III). It goes on to say: “at December 31, 2003, the fair value of the Firm’s lending-related commitments approximated the Allowance for lending-related commitments of \$324 million. At December 31, 2002, the fair value of the Firm’s lending-related commitments was approximately \$1.3 billion compared with Allowance for lending-related commitments of \$363 million.” We did not see an explanation as to why the fair value of loan commitments fell by about 75% during 2003.

The total balances of unfunded commercial-related commitments were \$176.2 and \$196.7 billion in 2003 and 2002, respectively. A table on page 50 of the report provides the distribution of the commitments by duration.

The 2003 report (note 29) also discusses off-balance-sheet, lending-related financial instruments and guarantees, with specific reference to FASB Interpretation (FIN) No. 45 requirements (see discussion of FIN 45 below, Section II). The report states, however, that “The majority of the Firm’s unfunded commitments are not guarantees as defined in FIN 45, except for certain asset purchase agreements...” (p.118).

A table on page 45 of the 2003 report informs on the maturity profile of the LCs (52%, less than one year; 45%, 1–5 years) and the rating profile of the guaranteed entities (88% are investment grade).

In contrast to the 2003 report discussed above, the 2002 report discloses LC fair values based on primary market prices, not credit derivative prices. The report states that “[on] this basis, the fair value of the Firm’s lending-related commitments approximated the allowance for lending-related commitments of \$363 million.” As indicated above, in the 2003 report this amount was revised up a year later almost four times to \$1.3 billion, relying on LCs’ fair value estimated from credit derivative prices.

(ii) **Allowance for Credit Losses**

**Citigroup**

Footnote 11 to the 2003 annual report includes the following line item:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Allowance for credit losses on unfunded lending commitments (in \$ millions)	600	567	450

It appears that the allowance refers to the total of “Loan Commitments” reported on page 146 (\$968.9 billion in 2003), of which “Commercial and consumer loan commitments” in 2003 amounted to \$210.8 billion. (The large majority of other loan commitments are “Credit card lines.”) We did not see a breakdown of the total allowance by type of commitments. Note 4 to footnote 11 of the 2003 report states: “Represents additional credit loss reserves for unfunded corporate lending commitments and letters of credit recorded with Other Liabilities on the Consolidated Balance Sheet.”

No specific information is given on the previous realized losses, if any, from loan commitments.<sup>7</sup> We did not see in the Allowance for Credit Losses footnotes of Citigroup in the 2001 and 2002 financial reports information on LCs.

### **Bank of America**

The 2003 annual report states that the reserves for unfunded lending commitments were (in \$ millions):

<u>2003</u>	<u>2002</u>	<u>2001</u>
416	493	597

Regarding the process of estimating the allowance, page 80 of the report states that it is “similar to the one described above for the loans and the lease portfolio.” We did not see in the 2002 and 2001 reports information on loss allowances related to LCs.

### **J.P. Morgan Chase**

The 2003 report states that the allowances for credit losses on lending-related commitments were \$324, \$363, and \$282 million in 2003, 2002, and 2001, respectively.

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<sup>7</sup> In the March 28, 2003 letter to the House Subcommittee, the FASB Chairman comments on the requirement to provide information about assumptions underlying estimates and realization of loan losses (in response to Question 3): “...existing financial accounting and reporting standards also require enterprises, including banks, to disclose (1)...the activity in the allowance for loan losses reported balance, (2) information about estimates used in determining the carrying amounts, of assets and liabilities, including estimates about loan losses...”

(iii) **Other LC-related disclosures**

J.P. Morgan Chase’s 2003 annual report provides information on the “loan equivalent” and “economic credit exposure” of lending-related commitments (pp.53–54):

“In determining the Firm’s Economic credit exposure to commercial lending-related commitments [in contrast with the contractual amount of commitments] the Firm has established a “loan-equivalent” amount for each commitment. The loan-equivalent amount represents the portion of the unused commitment or other contingent exposure that is likely, based on average portfolio historical experience, to become outstanding in the event of a default by the obligor. It is this amount that, in Management’s view, represents the Firm’s Economic credit exposure to the obligor.”

The relevant data are presented thus:

As of December 31 (in \$ billions)	<u>2003</u>	<u>2002</u>
Commercial lending-related commitments:		
Reported amount	\$216	\$238
Loan equivalent (“LEQ”) adjustment	<u>(109)</u>	<u>(123)</u>
Economic credit exposure	\$107	\$115

Summarizing the loan commitments disclosures of the three major providers of these instruments, we note the following:

- (a) The disclosures are highly inconsistent across the three banks and over time, and are often deficient in describing the credit risk of loan commitments. For example, while all three banks provide breakdowns of loan commitments by maturity (although one bank’s breakdown is somewhat vague), only one bank provides a breakdown by the credit rating of the guaranteed entities. While lender-protecting MAC clauses are mentioned, no quantitative information is provided about MAC frequency, and only

one bank provides information on loss realizations from LCs. These and other information items are essential for evaluating the credit risk of loan commitments.

(b) While all three banks state that the contractual (face) value of loan commitments does not represent the actual credit exposure of the bank, only one bank provides an estimate of such exposure (“Economic credit exposure”).

(c) Most importantly, while disclosure of the fair value of loan commitments is required when practicable (see footnote 3, above), only one bank provides this information.

We thus conclude that, on the whole, the current financial statement disclosure of loan commitments by the major providers of these instruments is insufficient to properly assess the risk to issuers, and to the public at large (due to deposit insurance), as well as the risk to equity holders from incorrectly assessing the values of LC providers. Nor is the disclosure informative about the rewards to this important banking activity, namely the periodic fees charged for loan commitments. Information about risks and rewards is essential for financial statement users, regulatory agencies, and policymakers. This then raises the question: Does GAAP provide for an improved disclosure of loan commitments, satisfying the needs of financial statement users? We believe that the answer is in the affirmative, as argued in the next section.

## **II. Current GAAP**

### **A. Loan Commitments as Guarantees**

FASB Interpretation No. 45 (FIN 45)<sup>8</sup> requires that guarantors *recognize* a liability for the fair value of the obligation undertaken at the inception of the guarantee, and moreover that they disclose relevant information about their guarantees in financial reports—primarily the

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<sup>8</sup> Financial Accounting Standards Board, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.” FASB Interpretation No. 45, November 2002.

nature, terms, performance triggers, recourse provisions, collateral, and the maximum potential amount of future payments on those guarantees.<sup>9</sup> Paragraph 3 of FIN 45 states that “the provisions of this Interpretation apply to guarantee contracts that have any of the following characteristics:

- (a) Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets...) to the guaranteed party, based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party...
- (d) Indirect guarantees of the indebtedness of others, as the phrase is used in paragraphs 17 and 18 (and originally in Interpretation 34), even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.”

The above characteristics appear to embrace loan commitments as guarantees defined by FIN 45: Loan commitments are contracts that require the guarantor to make payment to the guaranteed party, generally when a contingency in the form of a deterioration in financial position (tantamount to an implicit “underlying”) triggers a draw on the commitment (condition (a), above). Frequently, loan commitments serve as indirect (but important) guarantees of commercial paper issuances—condition (d) above (more on commercial paper below).

However, paragraph 4 of FIN 45 explicitly excludes loan commitments from the scope of the Interpretation: “Commercial letters of credit and other loan commitments which are commonly thought of as guarantees of funding, are not included in the scope of this Interpretation because those arrangements do not meet any of the four characteristics identified

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<sup>9</sup> FIN 45 supersedes FIN 34 (“Disclosure of Indirect Guarantees of Indebtedness of Others”) and clarifies certain aspects of FASB Statement No.5 (“Accounting for Contingencies”).

in paragraph 3 above.” An explanation to this somewhat puzzling statement by the FASB is given in paragraph A9 of FIN 45:

“Characteristic (a) in paragraph 3 encompasses a financial standby letter of credit, which is an irrevocable undertaking to guarantee payment of a specified financial obligation. But characteristic (a) does not encompass commercial letters of credit and other loan commitments, because those instruments do not guarantee payment of a money obligation and do not provide payment in the event of default by the account party.

- (a) ...The Board noted that, for financial standby letters of credit [which are included in the scope of FIN 45], amounts are drawn down (that is, payments are made by the issuing institution) only when the account party’s financial condition has deteriorated. [We note that this is typically the case for loan commitments, as well, and so does not distinguish LCs from other types of guarantees.]
- (b) Furthermore, financial standby letters of credit do not have material adverse change (MAC) clauses or similar provisions that enable the issuing institution (the guarantor) to avoid making payment. In contrast, many loan commitments contain MAC clauses or other similar provisions that enable the issuing institution to avoid making a loan if the borrower encounters financial difficulties after the loan commitment is issued.”

Thus, the major, and perhaps only, reason that loan commitments were excluded from FIN 45, despite functioning as important guarantees of most commercial paper issuances, is that “many loan commitments contain MAC clauses.” This, then, calls for a consideration of the nature of MAC clauses and their impact on the obligation underlying loan commitments, since accounting for LCs differently from the substantially substitutable guarantees without MACs

makes sense only if MACs are invoked to deny practically all cases of loan requests by financially distressed enterprises.

### **Material Adverse Change Clauses**

Material adverse change (MAC) clauses are often included in credit agreements, specifying that the issuer's obligation to extend the loan is conditional on there having been no significant change in the financial conditions and/or other specified circumstances of the borrower. For example, in the February 13, 2004 credit agreement between Albertson's, Inc. (borrower) and U.S. Bank National Association (the lender) on a \$100 million revolving loan, Section 7.2 ("Conditions to All Borrowings") states the following:

"The obligation of Lender to make any Revolving Loan or issue any Letter of Credit is subject to the satisfaction of the following conditions precedent on the relevant Borrowing Date:...

(c) No Material Adverse Effect. There has occurred since the date of the most recent Form 10-K or other public disclosure document filed by Borrower with the SEC prior to the Closing Date (to the extent any such event or circumstance is disclosed in such document), no event or circumstance that has resulted and could reasonably be expected to result in a Material Adverse Effect;"

And what are the circumstances constituting material adverse effects? The definition section of the revolver agreement states:

"Material Adverse Effect" means (a) a material adverse change in, or a material adverse effect upon, the operations, business, assets, liabilities or financial condition of Borrower and its Consolidated Subsidiaries taken as a whole; (b) a material impairment of the ability of Borrower to perform under any Loan Document and to avoid any Event of Default; or (c) a material adverse effect upon the legality, validity, binding effect or enforceability against Borrower of any Loan Document."

Our review of several loan documents suggests that the above specification of material adverse effects is typical.<sup>10</sup> These clauses generally relate to deterioration in the financial conditions of the prospective borrower, and its ability to repay the loan. The MAC definition seems rather general: In the documents we surveyed, there were no quantitative specifications of what constitutes an adverse change (e.g., negative earnings, a 50% reduction in book value, etc.). Furthermore, from the frequent reference in the agreements to “the most recent financial report,” it seems that a major objective of the MAC clause is to protect the lender from recent adverse events that were not publicly disclosed by the borrower.

The existence of MAC clauses in loan commitment agreements seems to be a nonsequitur, especially for large and creditworthy firms that currently have easy access to capital markets at attractive rates: A loan commitment is clearly aimed at providing a business enterprise with a safeguard or protection against financial deterioration—why else would a business draw on the commitment?—but if the financial deterioration releases the lender from its commitment, what’s the value of the safeguard? The fact that business enterprises are willing to pay for loan commitments, and that commercial paper issues are usually backed by loan commitments, suggests that there is more to the story of MACs than just an automatic mechanism for the lender to back out of the loan commitment. Furthermore, the large reserves banks make for expected loan losses on undrawn loan commitments (see Section I, above)—amounting to hundreds of millions of dollars for the three major providers LCs—imply that these banks expect companies in deteriorating financial conditions to draw on the commitments, and that some of such drawing

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<sup>10</sup> These MAC clauses are generally referred to as “financial MACs.” Credit agreements sometimes include environmental or litigation MACs, specifying regulatory environmental actions or litigation brought against the borrower.

requests will be granted.<sup>11</sup> It, therefore, seems clear that the presence of a MAC clause in a credit agreement is not always used by lenders to refuse a draw request by a financially distressed lender. Indeed, in several recent “celebrated” cases—such as WorldCom, Tyco International, El Paso, and Mirant—banks allowed enterprises undergoing obvious financial distress to draw on loan commitments despite the existence of MAC clauses in the credit agreement.<sup>12</sup>

Of particular note is the recent case of Marsh & McLennan Cos. Following a lawsuit by New York Attorney General Eliot Spitzer, and rating downgrades by Moody’s and Fitch Ratings, Marsh averted a financial crisis by negotiating with its banks a MAC waiver:

“The Company, sued by Mr. Spitzer a week ago, said its banks agreed to waive until Dec. 30 clauses in their credit agreements that would have allowed them to cut off short-term financing agreements due to ‘material adverse litigation’ or issues regarding ‘compliance with laws.’...Winning the banks’ waiver is crucial for Marsh’s short-term financial health. The bank agreements are somewhat like insurance: They provide credit lines that Marsh can draw on if it is unable to sell the short-term debt it uses, commercial paper, to finance its cash needs.” (*The Wall Street Journal*, October 21, 2004, p.A1).

Given that loan commitments with MACs were honored in the above seriously distressed cases, which involved probable losses on the resulting loans for the banks, it is reasonable to assume that draw requests by financially hard-pressed borrowers are frequently granted despite the existence of MACs in the agreement.

Indeed, there are good reasons for lenders not to invoke MAC clauses too frequently. It is well known that a major reason for banks to extend loan commitments is to enhance business relationships with borrowers. Loan commitments are often bundled with or followed by

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<sup>11</sup> Unless, of course, the entire loan loss reserve relates to commitments without MACs. Banks, however, do not provide information on loan commitments with and without MACs in financial reports and thus do not illuminate this issue.

<sup>12</sup> Information provided by Loan Pricing Corporation.

additional business, such as securities underwriting.<sup>13</sup> Obviously, a bank's refusal of a draw request will seriously harm such relationships.<sup>14</sup> Furthermore, a lender's reputation for a quick finger on the MAC trigger will harm the bank's credit and perhaps other business development activities.<sup>15</sup> Issuers of loan commitments are also concerned with the potential legal liability that arises from a refusal of a draw request on a loan commitment on the basis of a MAC clause that subsequently leads to the customers' bankruptcy.<sup>16</sup> Many MAC clauses are general and qualitative (e.g., "a material impairment in the ability of Borrower to perform...") and therefore open to dispute and interpretation in legal proceedings.

Our supposition that the existence of a MAC does not preclude a loan commitment from being drawn by financially distressed enterprises is also supported by the attitude that rating agencies hold toward MACs. For example, an article about Standard & Poor's approach for backup of commercial paper states:<sup>17</sup>

"The standard coverage has been 100% of confidence-sensitive paper outstanding...for all but the very strongest credits...This level of backup has provided a sense of security to commercial paper investors—even though backup facilities are not a guarantee that liquidity will, in the end, be available. (For

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<sup>13</sup> For example, The Wall Street Journal (June 9, 2004, p.1) reported on a survey of corporate-finance executives where "...96% of the corporate-finance executives at large companies who responded said they had been pressured by lenders to buy underwriting, merger advice and other services from a bank in exchange for loans."

<sup>14</sup> For example, Yasuda ("Do Bank Relationships Affect the Firm's Underwriter Choice in the Corporate-Bond Underwriting Market?") provides evidence that the *strength* of a bank's relationship with a borrower (rather than the existence of a relationship) strongly affects the likelihood that the bank will provide investment banking services for the borrower. Working paper, Wharton School, University of Pennsylvania, 2004.

<sup>15</sup> Boot, Greenbaum, and Thakor ("Reputation and Discretion in Financial Contracting") provide a theoretical explanation for how banks' desire to develop reputation leads to discretionary contract features such as MAC's, and why banks may waive those features. The American Economic Review, December 1993.

<sup>16</sup> Ergungor ("Theories of bank Loan Commitments," Ibid, p. 5) states that "courts limit banks' use of discretionary powers, often ruling that banks' use of the MAC clause is an *abuse of power and lack of good faith*" (emphasis in original).

Lu ("Market Value of Loan Commitment with Material Adverse Change (MAC) Covenant," Working paper, HEC, Universite de Lausanne, December 2002, p. 4) states that "On the bank's side, the potential legal damages and loss of reputation have forced most of the commitments to be honored, resulting in higher default losses and/or increasing the credit risk exposure...This discretionary element [i.e., the MAC] in the contract often becomes a legal issue and can lead to litigation afterwards."

<sup>17</sup> "Standard & Poor's Revises Its Approach for Backup of Commercial Paper," November 2, 1999. At [www2.standardandpoors.com/servlet](http://www2.standardandpoors.com/servlet).

example, a company would be denied funds if, its banks invoked “material adverse change” clauses...)”<sup>18</sup>

Thus, the existence of a MAC does not render the guarantee worthless. Furthermore, a Standard & Poor’s article on “Commercial Paper” states:<sup>19</sup>

“Industrial and utility issuers typically provide 100% backup—excess liquid assets or bank facilities—for paper outstanding...Payment for the [backup] lines—whether by fee or balances is important since it generally creates some degree of moral commitment on the part of the bank. Whether a facility is specifically designated for CP backup is of little significance... Even revolving credit agreements, which usually present the strongest commitment a bank can make, often include “material adverse change” clauses, allowing the bank to withdraw under certain circumstance. While inclusion of an escape clause weakens the commitment, Standard & Poor’s does not consider it critical—or realistic—for most borrowers to negotiate removal of “material adverse change” clauses.”

Noteworthy are the above comments on “the moral commitment on the part of the bank” and “Whether a facility is specifically designated for CP backup is of little significance.”

For the current view of rating agencies concerning MACs in loan commitments, we asked Loan Pricing Corporation (LPC) to discuss the MAC issue with the main agencies—Standard & Poor’s and Moody’s. Based on these discussions, LPC reports that practically all commercial paper issues are backed by loan commitments. In general, the existence of a MAC does not affect the backstop rating, and the agencies do not require commercial issuers to ask banks to remove the MACs. Regarding the types of MACs, the frequent “MAC at close” is not particularly effective in protecting the lender since it does not constrain a draw on the commitment. “MACs at draw” are less frequent, particularly for high grade borrowers.

Finally, a study based on Chase Manhattan bank data—six years ending December 2000, involving 1021 observations of 408 facilities for 399 defaulted borrowers—focused on the “loan

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<sup>18</sup> Standard & Poor’s revised criteria focus on a company’s maturity schedule, differentiating between companies that “are rolling over their commercial paper in just a few days and those that have a cushion by virtue of having placed longer-dated paper.” Ibid.

<sup>19</sup> “Rating the Issue: Corporate Ratings Criteria,” pp.75-76, at [www2.standardandpoors.com/servlet](http://www2.standardandpoors.com/servlet).

equivalent exposure” (LEQ) measure.<sup>20</sup> This measure is defined as the portion of a credit line’s undrawn commitment that is likely to be drawn down by the borrower in the event of default. The authors note the following (p.35): “In fact, the LEQ measures the outcome of the race between the bank and the borrower with regard to the draw-down of unused commitments in adverse circumstances.” A section of the study (pp.38–39) examines the experience of “advised lines,” which are credit lines “cancelable at any time by the bank, require approval prior to draw, and are generally reviewed annually.” (p.38). Although the authors do not explicitly discuss MAC clauses, “advised lines” provide lenders with as strong a protection as MACs. Nevertheless, the authors note that this subsample of “advised lines” is composed of “187 observations for 87 obligors for 87 facilities.” (p.3). Since this study focuses on borrowers’ defaults, it seems to indicate that defaulting borrowers drew on these “advised lines,” despite the bank’s ability to cancel the line prior to the draw.

Summarizing the MAC issue, although we are not aware of comprehensive statistics of the prevalence of MAC clauses in loan commitments, or the actual rate of draw-downs on commitments with MACs, the above discussion leads to the following conclusions:

- (a) Loan commitments obviously play an important role in the backup facilities used by most issuers of commercial paper (CP). In this sense, loan commitments are often “indirect guarantees of the indebtedness of others,” as defined by paragraph 3d of FIN 45.
- (b) Although MAC clauses might decrease the scope of the commitment relative to an unconditional guarantee, they certainly do not void it. Borrowers pay for loan commitments, indicating that they have a certain expectation of a draw being

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<sup>20</sup> M. Araten and M. Jacobs, “Loan Equivalents for Revolving Credits and Advised Lines,” The RMA Journal, May 2001, pp.34–40.

approved when the financial need arises; banks reserve considerable sums for loan losses on commitments with MACs; there are several “celebrated cases” where banks honored a loan commitment to enterprises undergoing clear and significant financial deterioration, despite the existence of MACs; and both Moody’s and Standard & Poor’s accept loan commitments with MACs as part of the CP backup line. Notably, we believe that in most cases where loan commitments are given by a consortium of banks, a *majority* of the members (and not 100%) is required to waive a MAC.<sup>21</sup> In such case, an individual member of a consortium can never be sure of its ability to deny credit to a distressed applicant by invoking the MAC.

- (c) We conclude, therefore, that the presence of MACs in loan commitments does not invalidate the underlying guarantee, and accordingly we do not find the exclusion of loan guarantees from FIN 45 justifiable.

#### **B. Loan Commitments included in “Multiple Deliverables”**

Loan commitments are often a component of a bundle of several products and services that are referred to in the accounting terminology as multiple deliverables. Thus, for example, a loan commitment is sometimes granted to a customer along with a regular loan, and/or with the underwriting of the customer’s bond or notes issue. Under certain circumstances, GAAP requires that the individual components of the bundle of multiple deliverables be accounted for separately. Each separate component is measured as the total consideration received for the bundle times the ratio of the stand-alone value of that component to the sum of the stand-alone

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<sup>21</sup> Indeed, the *Wall Street Journal* (October 21, 2004, p.A13) reporting on Marsh & McLennan notes: “Marsh officials started canvassing the banks over the weekend, learning that most would support a waiver.”

values of all the components of the bundle. In the absence of joint values to the components, this measurement should approximate the fair value of the component.

Emerging Issues Task Force (EITF) Issue No. 00-21, “Revenue Arrangements with Multiple Deliverables” (May 2003), defines multiple deliverables (paragraph 2) as: “...separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and should, therefore, be evaluated as a single arrangement...” For such arrangements EITF 00-21 calls for the following (paragraph 7):

- “Revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables in the arrangement meet the criteria in paragraph 9.”
- “Arrangement consideration should be allocated among the separate units of accounting based on their relative fair values...”

Regarding the units of accounting, paragraph 9 of EITF 00-21 states: “In an arrangement with multiple deliverables, the delivered item(s) should be considered a separate unit of accounting if all the following criteria are met:

- a. The delivered item(s) has value to the customer on a standalone basis...
- b. There is objective and reliable evidence of the fair value of the undelivered item(s).
- c. If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.”

Paragraph 12 of EITF 00-21 states that “If there is objective and reliable evidence of fair value for all units of accounting in an arrangement, the arrangement consideration should be allocated to the separate units of accounting based on their relative fair value... However, there may be cases in which there is objective and reliable evidence of the fair value(s) of the undelivered item(s) in an arrangement but no such evidence for the delivered item(s). In those

cases, the residual method should be used to allocate the arrangement consideration. Under the residual method, the amount of consideration allocated to the delivered item(s) equals the total arrangement consideration less the aggregate fair value of the undelivered item(s).”

Finally, and of particular relevance to loan commitments, is paragraph 16: “Contractually stated prices for individual products and/or services in an arrangement with multiple deliverables should *not* be presumed to be representative of fair value.”

### **Application of EITF 00-21 to loan commitments**

The first condition of separation of multiple deliverables to individual components (paragraph 9a) appears to be satisfied by loan commitments and the often-related other deliverables—regular loans or bond underwriting: Such deliverables have obviously value to the customer on a stand-alone basis, since they are often sold separately. Similarly, loan commitments are sometimes provided to customers without other services.

The second condition for the separation of multiple deliverables (paragraph 9b)—fair value evidence—is also generally met by loan commitments, because, as argued below (Section III), reliable evidence of fair values exists for many loan commitments.<sup>22</sup>

Accordingly, while important implementation issues of EITF 00-21 require further clarification, loan commitments that are part of a multiple-deliverables arrangement seem to qualify for treatment as a “separate unit of accounting,” to be recorded as liabilities and measured approximately at fair value upon initiation.

Summarizing, loan commitments seem to meet at least two existing GAAP requirements for fair value recognition as a liability: as a guarantee of commercial paper or other financing

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<sup>22</sup> The right of return condition (9c) does not appear to be applicable to loan commitments.

under Interpretation 45, and/or as a separate, not-yet-delivered component of a multiple-deliverables bundle under EITF Issue 00-21.

### **C. The Future Course of GAAP for Contracts**

A loan commitment is a contract that obviously affects, upon initiation, the risk and returns of both the lender and borrower. Although not all contracts are recorded upon initiation by the current accounting system (particularly executory contracts), standard-setters are clearly striving to continuously expand the scope of contracts recorded as assets or liabilities (e.g., postretirement benefits, and financial instruments), and, if possible, record them at fair value. This is the case even for contracts that include conditional language protecting one or both parties, such as the MAC clauses discussed above, or contracts where an obligation is implied by promises or by business conduct.

An example of this trend is SFAS 143 (2001), *Accounting for Asset Retirement Obligations*, where the FASB embraced the legal doctrine of “promissory estoppel” in requiring the recognition of liabilities for asset retirement obligations that the entity has promised to satisfy. In paragraph A2, the FASB quotes the following definition of this doctrine from Black’s Law Dictionary: “the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and promisee did actually rely upon the promise to his or her detriment.” In paragraph B25, the FASB states that such a promise can be “inferred from the entity’s past practice, which, absent evidence to the contrary, others can presume that the entity will continue.” We find this adoption of the concept of implied or expected promise particularly instructive in light of the cases discussed above where loans to financially distressed enterprises were provided, despite the existence of MAC clauses.

The most recent example of this trend of viewing contracts broadly is found in the FASB's ongoing revenue recognition project. In an update on this project (March 24, 2004), while stating that "[t]he Board agreed in principle that conditional rights and obligations do not meet the definitions of assets and liabilities...", the FASB states (Section 4):

"Contracts that include cancellation and "cancellation-like" provisions might give rise to assets and liabilities that should be recognized and measured at fair value, and concepts-level guidance should acknowledge that measurement uncertainties might dictate whether assets and liabilities that arise from contracts with "cancellation-like" provisions should be recognized. Concepts-level guidance should acknowledge that contractual promises may be express or implied. Liabilities that stem from implied contractual promises should be identified, recognized, and measured at fair value. Implied promises are inferred from a reporting entity's conduct, including its course of dealing with the counterparties..."

This apparent "current thinking" of the FASB concerning the possible recognition of cancelable contracts as liabilities, and the consideration of "implied promises" based on an entity's conduct as liabilities, seems to apply directly to loan commitments, even those with MAC clauses. In particular, we believe the implied promise in such loan commitments helps explain why banks honor them even when serious MACs are known to have occurred.

### **III. Implementation**

How can loan commitments be fair valued? In June 23, 2004 the FASB issued an Exposure Draft titled "Proposed Statement of Financial Accounting Standards: Fair Value Measurements," which is aimed at providing guidance for the fair value measurement of financial and nonfinancial assets and liabilities. The exposure Draft defines fair value (p.2) as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties." And goes on to state (p.2): "The objective of a fair

value measurement is to estimate an exchange price for the asset or liability being measured in the absence of an actual transaction for that asset or liability. Thus, the estimate is determined by reference to a current hypothetical transaction between willing parties.”

The Fair Value Exposure Draft (Section 7) discusses valuation techniques consistent with the “market approach, income approach, and cost approach [that] shall be considered for all estimates of fair value.”<sup>23</sup> The “market approach,” says the Exposure Draft, “requires observable prices and other information generated by actual transactions involving identical, similar, or otherwise comparable assets or liabilities.” (p.3). Markets in which assets and liabilities are exchanged vary in structure and level of activity. Such markets variously include “exchange market,” where “multiple identical exchange units are traded,” as well as “Dealer market,” where “dealers stand ready to trade,” and “Brokered market,” where “brokers attempt to match buyers with sellers but do not stand ready to trade for their own account.” (p.4). Finally, the Exposure Draft outlines a three-level fair value hierarchy (Sections 14–24), based on the availability of (a) “quoted prices for identical assets or liabilities in active reference markets;” (b) “quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for differences;” and (c) “multiple valuation techniques consistent with the market approach, income approach, and cost approach.” (Section 23 of the Exposure Draft notes that “valuation techniques used for Level 3 estimates shall emphasize market inputs....”)

Thus, the FASB’s fair value Exposure Draft makes it clear that the market approach, where market prices for identical or similar assets or liabilities can be found, is the preferred approach for determining fair value. Are such market prices available for loan commitments?

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<sup>23</sup> Footnote 6 says that “for estimates of fair value that are developed using quoted prices in active markets (an application of the market approach), the results of other valuation techniques may not provide significant additional information.” We too will focus in this report on the market approach to fair value.

## **The Credit Risk Market**

Loan commitments are major instruments in the credit risk market. In this market, a “protection buyer” pays a fee to a “protection seller” for assuming a credit risk. In the case of a loan commitment, the guaranteed party pays a fee to the guarantor (usually a financial institution) for assuming the risk of providing funds when the financial conditions of the former require it to draw on the loan commitment. In principle, the fee for the transfer of risk via the loan commitment should primarily depend on two elements: the probability of the draw on the commitment and the expected loss to the guarantor (that is, the drawn funds, including interest, that will not be repaid). Obviously, the higher the probability of the draw and the expected loss from unrepaid funds, the higher the loan commitment fee should be. In practice, loan commitment fees can differ from the theoretically required fees (based on the probability and loss of a draw) because the loan commitment is often bundled with related services (e.g., securities underwriting) offered or expected by the guarantor.<sup>24</sup>

The primary risk determinants of loan commitments are also shared by other major instruments in the credit risk market, in particular, credit derivatives. The principal and fastest growing component of these derivatives is the credit default swap (CDS), which is a contract protecting the holder of a bond, or other fixed obligation, from losses incurred when the obligation issuer defaults or otherwise fails to honor the bond’s terms.<sup>25</sup> The protection buyer in a CDS pays the seller an upfront fee and periodic payments (spread or premium), typically a percentage of the notional amount of the CDS. The default swap settles either by cash (the buyer

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<sup>24</sup> The financial press raised the issue of related services on various occasions in recent years. See, for example, “Showdown on Wall Street: Banks are Getting Business at the Expense of Elite Firms,” The New York Times, June 15, 2001, Section C, p.1; “Truth in Lending,” Barron’s, May 28, 2001; “The Cost of Leading Business into Temptation,” Financial Times, March 7, 2001.

<sup>25</sup> The CDS is generally conditioned on “credit events” that trigger it, such as default, obligation acceleration, or restructuring.

keeps the bond and is compensated for the loss of its value), or by a physical settlement (the buyer delivers the bond to the seller and receives the full notional amount).<sup>26</sup>

Like loan commitments, the primary determinants of the price (spread) of credit default swaps are the probability of default of the obligation issuer and the expected loss to the CDS seller upon default.<sup>27</sup> This common risk profile provides an important link between the theoretical prices of loan commitments and those of credit derivatives. Reflecting this relationship, banks often use credit derivatives to economically hedge the credit risk of loans and loan commitments.<sup>28</sup>

Bonds and other fixed obligations issued by the guaranteed party are also related to loan commitments via the cash credit markets. A bond's credit spread, that is the difference between the yield on the bond and the yield on a similar maturity riskless (government) bond, reflects the former's default probability and expected loss to holders—the same primary determinants of the prices of both loan commitments and CDSs. Indeed, empirical studies establish a close relationship between bond and CDS spreads, although the latter lead the former in terms of price discovery (that is, CDS prices react faster to company and economic events than do bond prices).<sup>29</sup> Various studies also empirically establish that CDS spreads react quickly to major credit events, such as changes in bond ratings, and issuers' reviews (watchlists) by bond raters.<sup>30</sup>

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<sup>26</sup> For elaboration, see Houweling and Vorst, "Pricing Default Swaps: Empirical Evidence," 2003, forthcoming Journal of International Money and Finance.

<sup>27</sup> Empirical studies confirm that the obligation issuer's bond rating and change in stock price—both reflecting default probability—are strongly related to the spread, or price, of CDSs. See, for example, Cossin and Hricko, "Exploring for the Determinants of Credit Risk in Credit Default Swap Transaction Data," 2001, Working Paper, HEC, University of Lausanne, Switzerland.

<sup>28</sup> For example, J.P. Morgan Chase and Co. discloses on page 60 of its 2003 annual report that it uses credit derivatives to hedge \$22.5 billion of its loans and lending-related commitments.

<sup>29</sup> See, for example, Blanco, Brennan, and Mrash, "An Empirical Analysis of the Dynamic Relationship Between Investment Grade Bonds and Credit Default Swaps," 2003, Working Paper, Bank of England, and Hull, Predescu, and White, "The Relationship Between Credit Default Swap Spreads, Bond Yields, and Credit Rating Announcements," 2004, Working Paper, Rotman School of Management, University of Toronto.

<sup>30</sup> For example, Hull, Predescu, and White, *Ibid*.

Thus, the link between prices of fixed obligations and those of CDS was established on both theoretical and empirical grounds.<sup>31</sup>

The conceptual and empirical linkages and commonalities among the various instruments in the credit and risk markets (primarily loan commitments, fixed-rate obligations, and credit derivatives) provide, in our opinion, a solid theoretical basis and often the practical means for assessing the fair value of loan commitments. The ready availability of bond yields, and the fast-increasing availability of CDS data in real time, facilitates the fair valuation of loan commitments. In addition, loan commitments are occasionally traded in secondary markets,<sup>32</sup> in which case identical market prices (top fair value hierarchy) are available for the fair value of loan commitments.

### **Fair Value Adjustments**

To be sure, the various instruments in the credit and risk markets are not perfect substitutes (namely, rarely meet the top hierarchy in the FASB's Fair Value Exposure Draft—quoted prices for identical assets). For if they were perfect substitutes there would be no need for distinct instruments. It is thus not difficult to point out differences among the instruments. For example:

- ◇ While there are no restrictions on trade in bonds and CDSs, there are sometimes conditions set by the borrower that limit the assignment of loan commitments for trade in the secondary market.
- ◇ In case of default, the claim on a drawn loan commitment may have seniority over a bond's claims.

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<sup>31</sup> To the best of our knowledge, there are no empirical studies linking loan commitment spreads with those of bonds or CDS. The reason is probably the harder access to comprehensive and transparent loan data, relative to bond or CDS information.

<sup>32</sup> For example, J. P. Morgan Chase and Co., on p.61 of its 2003 Annual report, discloses that “[d]uring 2003, the Firm sold \$5.2 billion of loans and commitments, of which \$1.3 billion was criticized.”

- ◇ The CDS market is liquid up to five years, whereas many loan commitments, primarily due to regulatory capital requirements, are extended for 364 days.<sup>33</sup>
- ◇ Issuers of loan commitments are sometimes privy to certain inside information of borrowers that holders of bonds or CDSs do not share.

Whereas some of the differences across instruments may not have a significant effect on prices and can therefore be ignored in the fair value assessment, other differences could have a more substantial effect on prices and will have to be considered in the determination of loan commitment fair value.

Furthermore, while the credit derivatives markets are fast growing,<sup>34</sup> specific segments of these markets are relatively illiquid at various times. Such illiquidity of the derivatives or the loan commitment secondary markets should also be considered in the process of fair value. The burgeoning empirical evidence can be helpful in making some of the necessary adjustments. For example, Zhu (p.13) reports on the estimated effect of the liquidity of the CDS market on prices: “[T]he difference in the number of CDS quotes [a liquidity proxy] can cause a maximum of 25–30 basis points in average basic spreads.”<sup>35</sup> It is also possible, of course, to restrict in practice the application of fair value of loan commitments to cases where the guaranteed party has bonds outstanding and/or relatively liquid credit derivative instruments. This will increase the reliability of loan commitment fair values.

In December 2002 Loan Pricing Corporation (LPC) introduced the Cross Markets Comps Grid,<sup>36</sup> which compares and evaluates investment grade borrowers across the primary loan

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<sup>33</sup> It should be noted that the major providers of loan commitments discussed in Section I have roughly 40% of the commitments extending beyond one year.

<sup>34</sup> The British Banker’s Association 2001/02 Credit Derivatives Survey reports that the total volume of credit derivatives (notional outstanding) increased continuously from \$40 billion in 1996 to \$1,952 billion in 2002.

<sup>35</sup> Zhu, “An Empirical Comparison of Credit Spreads Between the Bond Market and the Credit-Default Swap (CDS) Market,” 2003, Working Paper, Bank for International Settlements, Basel, Switzerland.

<sup>36</sup> LPC Gold Sheets, December 9, 2002.

market, the secondary loan market, the CDS market, and the bond market. The grid is essentially a table that specifies for certain companies the yields or spreads on loans in the primary and secondary markets, as well as on CDSs and bonds. According to LPC, comparisons of yields across markets can provide pricing information for banks and investors, as well as information about such implied parameters as the cost of supporting bank relationships (inferred from the difference between the CDS spread and the yields on the loan, or the loan commitment).

In 2003, LPC discussed the relative value pricing (RVP) approach, which they claim “more banks are beginning to tinker with.”<sup>37</sup> Under RVP, the terms of a loan and/or a loan commitment include an explicit component linked to the bond or the CDS markets. Examples of agreements with RVP (e.g., Tyco, Weyerhaeuser) are given in the LPC publication. The cross markets grid and the relative value pricing are mentioned here as examples of recent credit and risk market developments which are based on cross-markets valuation and pricing methodologies, that will increasingly facilitate the assessment of the fair value of loan commitments.

Summarizing, while differences between loan commitments and other instruments in the credit and risk markets exist, such differences seem to qualify the fair value determination of loan commitments as fitting “level 2” (price effect of differences is objectively determinable), or “level 3” (differences are not objectively determinable) of the FASB fair value hierarchies. Notably, some banks already perform valuations of certain aspects of loan commitments by relation to similar instruments. Thus, in the notes to its December 31, 2003 financial report

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<sup>37</sup> LPC Gold Sheets, June 16, 2003.

(p.122), J.P. Morgan Chase states that “[t]he Firm estimates the fair value of its commercial commitments to extend credit based on the cost of credit derivatives.”<sup>38</sup>

#### **IV. Conclusions**

Our examination of the current public disclosure of information about loan commitments by the major providers of these pervasive and economically important financial instruments led to the conclusion that the disclosures are inconsistent and largely deficient. We believe that users of financial reports, be they investors or policymakers, do not currently receive comparable and sufficient information to assess the risks and rewards inherent in loan commitments.

This conclusion led us to search the GAAP framework for pronouncements that will substantially improve the disclosure of information about loan commitments. We believe that two pronouncements in particular—FIN 45 and EITF 00-21—apply to loan commitments. Both pronouncement call, in our interpretation, for the recording of loan commitments at fair value upon initiation, and the recognition of the fair value of the underlying liability in the issuers’ financial reports.

This then raises the implementation issue of assessing the fair value of loan commitments. Although trade in loan commitments (secondary market) is sometimes limited, there are sufficiently close and widely traded instruments—bonds and credit derivative swaps, in particular—that can provide for “level 2” or “level 3” fair value determination. We, therefore, believe that the accounting recognition of loan commitments at fair value upon initiation is both consistent with the spirit of GAAP and feasible from an implementation point of view. Most

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<sup>38</sup> In a June 15, 2000 letter to the FASB, J.P. Morgan wrote: “[C]urrently while decisions in our Credit Portfolio business are made on a fair value basis, performance is measured on an accrual basis... We anticipate transforming to a fair value model for this portfolio later this year. As transparency around the credit pricing has improved, it has become possible to find public quoted prices and parameters (spreads) for credit instruments facilitating this change.”

importantly, such recognition will substantially improve the information available to capital markets and policymakers.