

OTTI:

What is it?

What does it mean for credit unions?

OTTI:

Other-Than-Temporary Impairment

What does *that* mean?

OTTI: What is it?

- OTTI is a technical accounting term used to reflect a certain type of loss – or *impairment*.
- OTTI indicates an assumption of a very significant likelihood that the full value of an asset will not be recovered.
- Accounting rules require that OTTI be recorded as write-downs on the income statement.

What does OTTI mean to you?

It's an issue you'll continue to hear about as large financial institutions, including corporate credit unions, report OTTI as a part of their financials.

OTTI is one of several types of *impairments*. Let's drill down a little further into what this is...

What is an Impairment?

An impairment exists when the book value of an asset, such as a bond, exceeds its fair value.

Then what is Fair Value?

Fair value is the amount an asset, such as a bond, could be bought or sold for in a transaction between willing parties.

There are three types of Impairments

- Temporary
- Permanent
- Other-Than-Temporary Impairment

Temporary Impairment

Temporary Impairment: What happens?

Example 1:

Interest rates increase, causing the value of a bond to decrease.

- \$100 bond is purchased at 4%
- Interest rates increase
- Value of your \$100 bond decreases b/c investors who buy a *new* \$100 bond would receive better yield

Temporary Impairment: What happens?

Example 2:

The market for
buying or selling
securities is frozen.

- Corporate credit union purchases a AAA security for \$X million.
- The market freezes up – very few securities sales/almost no demand.
- If Corporate credit union were to sell the security today, it would receive only \$Y million.

What's the accounting treatment?

- The current market price for a bond is established through the “mark-to-market” process.
- An *unrealized* loss represents the difference between the bond's cost and what it could be sold for today.
- This amount is recorded (or “written down”) in the equity section of the balance sheet under Accumulated Other Comprehensive Income/Loss (AOCI).
- Increases in value above the price paid can be added back to equity.

Permanent Impairment

Permanent Impairment: What happens?

Example: A company defaults on its debt, and the bond no longer has value.

- The bond issuer is unable to pay principal back to the investor.
- The value of the bond is diminished or eliminated completely.

What's the accounting treatment?

- The entire loss of the bond is recorded on a company's income statement.
- There is no opportunity to regain the lost value of the investment.

Other-Than-Temporary Impairment (OTTI)

OTTI: What happens?

- 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.
- It is likely that investors will be unable to collect the *full* value of a bond.

What's the accounting treatment?

- A loss is recorded in the income statement for the difference between the fair value and the book value of the security.
- The fair value is based upon current market prices, not on realizable value.
- The adjusted book value is amortized to the realizable value over the remaining life of the security.

OTTI vs. AOCI

What's the difference?

What's AOCI?

- Accumulated Other Comprehensive Income
 - A component of equity where unrealized gains and losses of certain securities are recorded.
 - **Temporary impairments** are reflected as unrealized losses in AOCI.

Other-Than-Temporary Impairment

Example:

| | |
|----------------------|--------------|
| Book Value | \$10,000,000 |
| Fair Value | \$ 8,000,000 |
| Net Realizable Value | \$ 9,500,000 |

- Impairment of \$2,000,000 is recorded in income statement.
- Because the security is not sold at today's "fair value" the investor recovers \$1,500,000 over the remaining life of the security.
- Actual loss: \$500,000 v. \$2 million recorded "today"

Accounting Rules vs. Economics

Accounting rules vs. economics

- Currently, there is a large gap between accounting standards (*i.e.*, “fair value”) and economics (*i.e.*, net realizable value.)
- Theoretically, these two should be closer.

Why the difference between the two?

- The **economic loss** represents the principal you do not expect to receive.
- The **accounting loss** is the difference between the book value and “fair value.”
- However, in this extremely illiquid market, fair values are VERY low, making the accounting loss MUCH worse than the economic loss.

How did we end up here?

Market Dislocation History

- Since the summer of 2007, prices of securities, even those rated “AAA,” have been driven down by lack of liquidity in the market and fears about credit losses in certain sectors.
- Given the lack of liquidity, there are very few buyers. The lack of demand relative to supply is keeping the prices down.

Market recap

- Following an expanding housing bubble from 2001-2005, prices began to decline in several markets in 2006 – resulting in a rise in delinquencies and foreclosures.
- Early in 2007, the subprime industry collapsed – many subprime lenders declared bankruptcy or announced significant losses.
- During the second half of 2007, the effects of underperforming residential mortgages and related securities resulted in a severe dislocation of the credit markets.

Market recap

- The deterioration in mortgages and mortgage securities has spread to other sectors of the credit markets.
- Ratings agencies downgraded 15,000 bonds in 2007, relative to 200-300 in typical year, and has downgraded more than 30,000 in 2008; the effect on unrealized losses was deepened by downgrades of monoline bond insurers in 2008.
- Each cycle of downgrades causes a further erosion of market prices...deepening unrealized losses and driving further downgrades – a downward spiral.

OTTI and Loan Loss Reserves

Similar in nature – but with
different treatment.

How is OTTI different from loan loss reserving?

Back to the example:

| | |
|------------------------|--------------|
| • Book Value | \$10,000,000 |
| • Fair Value | \$ 8,000,000 |
| • Net Realizable Value | \$ 9,500,000 |

OTTI vs. loan loss reserving

- Loan loss accounting would have required a reserve of \$500,000 established through the income statement. As actual losses are realized over time, the reserve is increased or decreased depending upon whether true losses were higher or lower than estimated.

OTTI vs. loan loss reserving

- In comparison to loan loss reserving, OTTI is a “one-way street.”
- You can always continue to write down the value of the security.
- However, if you over-estimate the amount of OTTI, you cannot reduce the write down.

OTTI in Perspective

- By regulation, corporate credit unions invest only in high-quality securities.
- Due to the extreme market dislocation, even the highest-quality securities have been affected.

OTTI in perspective

- OTTI is an estimate. Among the many variables considered in estimating potential OTTI are:
 - Voluntary prepayments
 - Involuntary prepayments/default rate
 - Recoveries
 - Credit structures and enhancements
 - Note: Most mortgages are for 30-year terms, so these estimates extend far into the future.

Strength and safety

- Despite the OTTI issue, corporate credit unions are strong and solid.
 - The Corporate Network had more than \$8.6 billion in total capital at September 30, 2008 (includes U.S. Central).
 - Earnings of the Corporate Network were \$166.9 million through September 30, 2008 (includes U.S. Central).
 - The Corporate Network is a strong source of liquidity and services.

For more information...

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