

Legislative Audit and Fiscal Review Committee
Testimony of Eric Hardmeyer, Bank of North Dakota
July 16, 2014

Mr. Chairman and members of the Committee for the record my name is Eric Hardmeyer; I am the President and CEO at the Bank of North Dakota. I am here to discuss the two separate accounting standards that BND uses to report its operating results and why it's important for this committee to understand how the two methodologies can result in significant differences within BND's financial statements.

As a financial institution, BND follows the standards set by the Financial Accounting Standards Board (FASB) to complete our financial statements. It's these financial statements that we use to report our earnings and growth numbers at the end of the year. Rating services, regulators, and other banks also rely on the FASB financial statements to gauge the success of BND. As a state agency, BND is also required to complete its financial statements under the Governmental Accounting Standards Board (GASB) which is used for governmental agencies. The State uses this information to report BND's earnings in the Comprehensive Annual Financial Report (CAFR).

The difference in these two sets of financial statements lies in the treatment of items that flow through the income statement. Under FASB, gains or losses in the investment portfolio for available for sale securities only flow through the balance sheet as an adjustment to equity. GASB requires these same gains or losses flow through the income statement. Consequently, the income reported under the two methodologies can be very different. The first attachment illustrates the difference between the 2013 income statements prepared under FASB and GASB.

In the last four years as a result of increased revenue taken into the state coffers, deposits at BND have grown substantially. Deposits are used to fund loans; if loan demand does not keep up with deposit growth the residual funds are invested into securities to maximize earnings. In our situation, as it is with most ND banks, that is the case – tremendous deposit growth with average loan growth.

This has had a significant impact on the structure of the bank's balance sheet. Since 2010, the investment portfolio has grown from \$500 million or 13% of its assets to over \$3 billion or 41% of assets. As interest rates rise or fall, the market value of these securities will move up or down counter to the change in interest rates. Consequently, there may be considerable differences in the income reported under FASB and GASB.

Interest rates have been at historical lows and kept there through fed action since the financial crisis began in 2008. We believe the likely direction of interest rates will be upward, but are unsure when that will begin. The second illustration shows the effect of several different interest rate changes and how each rate change would have impacted BND's earnings reported under GASB over the past 4 years. As you can see, the impact of rate changes has grown significantly as the investment portfolio became a more significant percentage of BND's total assets.

We are concerned how this could be interpreted should BND have a significant difference between our FASB and GASB prepared financial statements. While we will continue to report our financial results using FASB, it's important for you to be aware of these differences and the potential impact on BND's financial reporting.

Bank of North Dakota
FASB vs. GASB Analysis
As of 12/31/2013
In Thousands

	FASB Income Statement		GASB Income Statement		Difference	Footnote
Interest Income						
Federal Funds Sold	211		211		-	
Securities	19,985		13,091		(6,894)	1
Loans	132,986		134,607		1,621	2
Total Interest Income	<u>153,182</u>		<u>147,909</u>		<u>(5,273)</u>	
Total Interest Expense	<u>30,217</u>		<u>30,217</u>		<u>-</u>	
Net Interest Income	122,965		117,692		(5,273)	
Noninterest Income						
Service fees and other	7,639		7,639		-	
Net increase/(decrease) in the fair value of securities	(217)		(10,047)		(9,830)	3
Total Noninterest Income	<u>7,422</u>		<u>(2,408)</u>		<u>(9,830)</u>	
Total Noninterest Expense	<u>36,172</u>		<u>36,172</u>		<u>-</u>	
Net Income (Income before Transfers GASB)	<u>94,215</u>		<u>79,112</u>		<u>(15,103)</u>	

(16,724)

The total amount of mark to market adjustment on securities between 2012 and 2013.

Footnotes:

- 1 GASB requires the market value adjustment on the securities (investments) to be reflected on the income statement while FASB reflects the market value adjustment on the balance sheet as an adjustment to equity under Accumulated Other Comprehensive Income. The adjustment to the securities reflects the mark to market value adjustment of net amortizations or (accretions) within the investment portfolio.

- 2 GASB and FASB differ on how the loan fees are recognized as income. GASB 65 requires that loan fees be recognized when received while FASB recognizes the fees over the life of the loan.

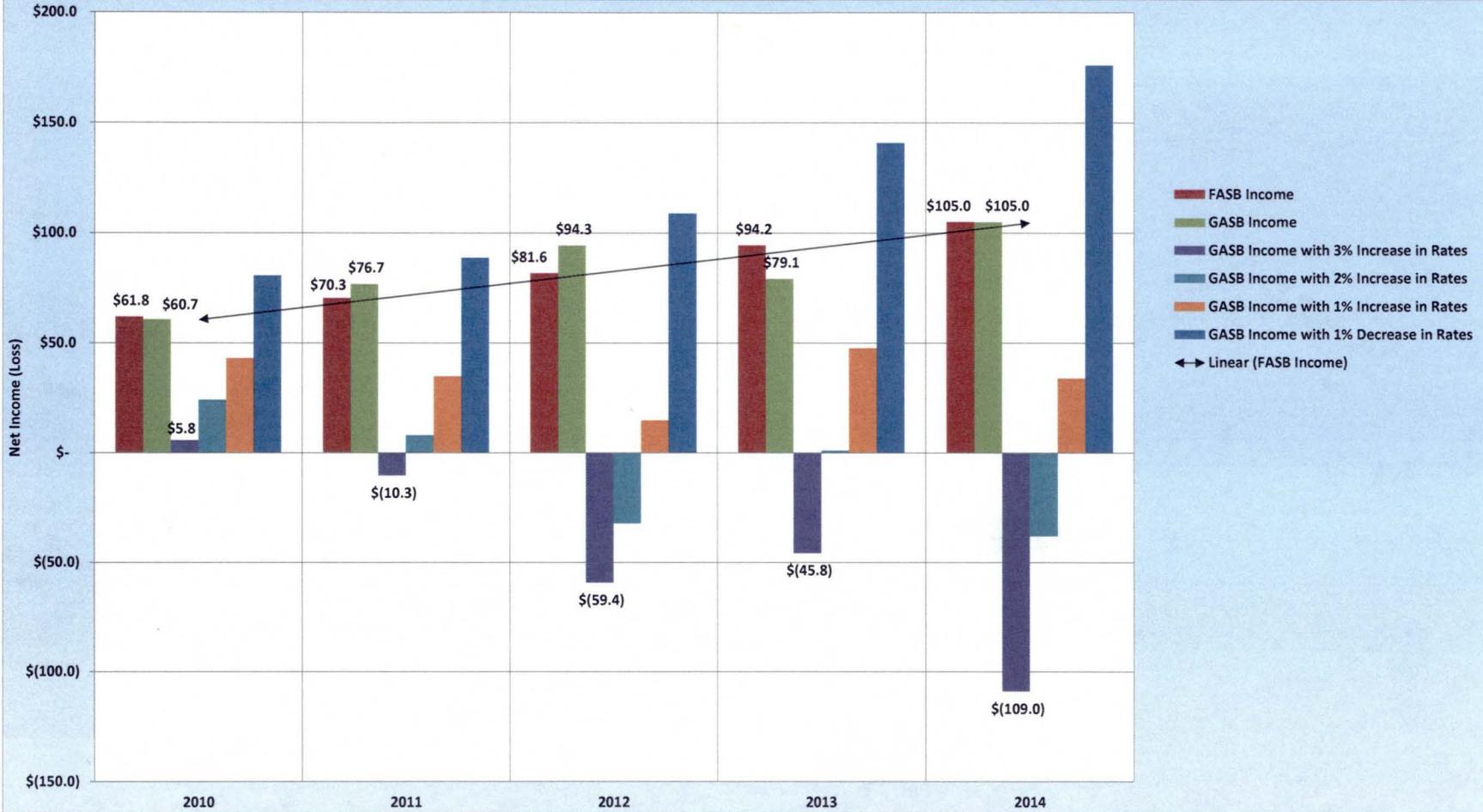
- 3 GASB requires the market value adjustment on the securities to be reflected on the income statement while FASB reflects the market value adjustment on the balance sheet as an adjustment to equity under Accumulated Other Comprehensive Income. At the end of 2012, BND showed a mark to market gain of its investment portfolio of \$16.816 million. At the end of 2013, the mark to market gain on investments was \$92 thousand, or a reduction of \$16.724 million. That amount is reflected in the combined adjustment to securities (-\$6.894 million) and net increase (decrease) in the fair value of securities (-\$9.83 million).

Bank of North Dakota
FASB vs. GASB Analysis
 In Millions

	12/31/2010	12/31/2011	12/31/2012	12/31/2013	Projected 12/31/2014
Investment Portfolio	\$ 537	\$ 1,008	\$ 2,172	\$ 2,584	\$ 3,064
Investment % of Total Assets	13%	19%	35%	38%	41%
FASB Income	\$ 61.8	\$ 70.3	\$ 81.6	\$ 94.2	\$ 105.0
Rates Rise 3% Mark to Market*	\$ (56.0)	\$ (80.6)	\$ (141.0)	\$ (140.0)	\$ (214.0)
GASB Income after Mark to Market	\$ 5.8	\$ (10.3)	\$ (59.4)	\$ (45.8)	\$ (109.0)
FASB Income	\$ 61.8	\$ 61.8	\$ 61.8	\$ 94.2	\$ 105.0
Rates Rise 2% Mark to Market*	\$ (37.5)	\$ (53.7)	\$ (94.0)	\$ (93.0)	\$ (143.0)
GASB Income after Mark to Market	\$ 24.3	\$ 8.1	\$ (32.2)	\$ 1.2	\$ (38.0)
FASB Income	\$ 61.8	\$ 61.8	\$ 61.8	\$ 94.2	\$ 105.0
Rates Rise 1% Mark to Market*	\$ (18.8)	\$ (26.9)	\$ (47.0)	\$ (46.5)	\$ (71.0)
GASB Income after Mark to Market	\$ 43.0	\$ 34.9	\$ 14.8	\$ 47.7	\$ 34.0
FASB Income	\$ 61.8	\$ 61.8	\$ 61.8	\$ 94.2	\$ 105.0
Rates Decline 1% Mark to Market*	\$ 18.8	\$ 26.9	\$ 47.0	\$ 46.5	\$ 71.0
GASB Income after Mark to Market	\$ 80.6	\$ 88.7	\$ 108.8	\$ 140.7	\$ 176.0

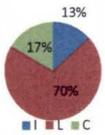
*For comparative purposes illustrates what the mark to market adjustment would amount to assuming the identified shock in interest rates during the respective time periods.

Impact of Interest Rate Changes on GASB Net Income (In Millions)

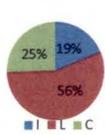


- FASB Income
- GASB Income
- GASB Income with 3% Increase in Rates
- GASB Income with 2% Increase in Rates
- GASB Income with 1% Increase in Rates
- GASB Income with 1% Decrease in Rates
- ↔ Linear (FASB Income)

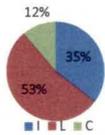
Percent of Total Assets



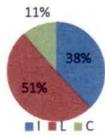
Percent of Total Assets



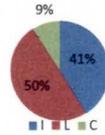
Percent of Total Assets



Percent of Total Assets



Percent of Total Assets



- Investments
- Loans
- Cash