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September 9, 2009

The Honorable Timothy Geithner
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Ben S. Bernanke
Chairman
Federal Reserve Board
Eccles Board Building
20th and C Streets, NW
Washington, DC 20551

Re: G-20 Accounting Recommendations

Dear Secretary Geithner and Chairman Bernanke:

The American Bankers Association¹ respectfully requests that you include the impact of current accounting proposals, and whether they are consistent with the recommendations of the April G-20 report, on the agenda for the upcoming G-20 summit on September 24-25. This is a critical time for the G-20 to continue its discussions on accounting because the international accounting rules for financial instruments are currently scheduled to be finalized shortly after the summit.

Generally, we agree with the accounting recommendations set forth in the G-20 paper, "Declaration on Strengthening the Financial System",² and we appreciate the level of priority that the G-20 has placed on this extremely important topic. However, we have serious concerns about the direction being taken by the accounting standard setters. We believe that the results of their deliberations will not achieve what the G-20 had hoped to achieve and, in fact, are contrary to the G-20 recommendations. For example, proposals of the accounting standard setters:

¹ The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$13.3 trillion in assets and employ over 2 million men and women.

² See Appendix 1 for accounting recommendations from the G-20 Report.

- **Increase the procyclical impact of accounting standards.** Both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are proposing to *increase* the use of “mark to market” accounting, which experts believe is procyclical.³ Thus, the proposals are contrary to the recommendations of the G-20 to make accounting less procyclical.⁴ Many agree that procyclicality has exacerbated the financial crisis,⁵ including the G-20 Working Group on Enhancing Sound Regulation and Strengthening Transparency, which noted in its final report that procyclicality is one “of the more salient weaknesses identified as drivers of the current turmoil.”⁶
- **Undermine the relevance of the banking business model.** The proposals will decrease the ability of investors and regulators to understand the business of banking. Mark to market does not reflect the business model for the traditional banking business. Therefore, the proposals are contrary to the G-20 recommendation that “the accounting standard setters should improve standards for the valuation of financial instruments based on their liquidity and investors’ holding horizons”⁷; do not follow the Group of Thirty view that standards should “better reflect the business model” of “financial institutions that intermediate credit and liquidity risk”⁸; do not

³ ABA agrees with the use of mark to market for assets that are traded; however, the traditional banking model is to hold loans and debt instruments for their contractual cash flows. Therefore, the increase in the use of mark to market that is being discussed by the standard setters would provide misleading information.

⁴ In the G-20 Report, “Declaration on Strengthening the Financial System” (London, April 2, 2009), the G-20 agreed to strengthen international frameworks for prudential regulation in a several ways, including the following: “the FSB, BCBS, and CGFS, working with accounting standard setters, should take forward, with a deadline of end 2009, implementation of the recommendations published today to mitigate procyclicality, including a requirement for banks to build buffers of resources in good times that they can draw down when conditions deteriorate.” The Report also included the following statement on accounting and procyclicality: “We also welcome the FSF recommendations on procyclicality that address accounting issues.”

⁵ See Appendix 2 for quotes on procyclical accounting.

⁶ G-20 Working Group 1: “Enhancing Sound Regulation and Strengthening Transparency Final Report”, March 25, 2009.

⁷ G-20 Report: “Declaration on Strengthening the Financial System”, London, April 2, 2009.

⁸ Group of Thirty Report: “Financial Reform – A Framework for Financial Stability”, January 15, 2009: “The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions, apply appropriate rigor to valuation and evaluation of intent, and require improved disclosure and transparency.”

meet the Basel Committee's principles which state that, for "faithful representation," the new standard should reflect the business model so that banking transactions are "portrayed in a robust and consistent manner in line with their economic substance"⁹; and do not meet the U.S. Treasury Department's principles for reforming the regulatory capital framework for banking firms."¹⁰

The proposals also will dramatically change banking business models and products. Financial institutions, large and small, will be evaluated based on a mark to market basis, rather than the traditional banking model. This will result in:

- reduced lending, at a time when credit needs to expand
- changes of product types available to customers
- increased cost of capital to the banking system
- increased cost of credit to borrowers

These results would contradict the overall G-20 program, which focuses on stabilizing, rather than dramatically changing, the traditional business of banking.

- **Disrupt efforts toward international convergence.** The FASB and IASB have two different proposals with two different time frames for implementation, which will disrupt the goal of international convergence of accounting standards.¹¹ This contradicts the G-20 recommendation that the standard setters should "make significant progress towards a single set of high quality global accounting standards."
- **Focus on wholesale changes rather than the needed repairs.** Most experts, including banking leaders, believe that repairs are needed to the accounting model, particularly in the area of provisioning for loan losses.¹²

⁹ The Basel Committee on Banking Supervision: "Guiding principles for the replacement of IAS 39", August 27, 2009.

¹⁰ U.S. Department of the Treasury: "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms," September 3, 2009: "The regulatory capital and accounting frameworks should be modified in several ways to reduce their procyclicality."

¹¹ The current economic crisis has demonstrated how important it is to ensure that these new accounting standards (particularly loans and debt securities) be the same, globally. The IASB plans to finalize its rules for use by year-end 2009, while the FASB plans to finalize its rules in 2010. Therefore, it appears that either U.S. GAAP will not be similar to international standards, or, for the sake of convergence, U.S. constituents may be faced with having to accept what will be recently-enacted international rules without having the ability to have an appropriate level of "due process" (which should include discussions with U.S. banking industry preparers and users of financial statements, exposure for comment, etc.).

¹² U.S. Department of Treasury (Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation, June 2009): "We recommend that the accounting standard setters improve accounting standards for loan loss provisioning by the

We believe the G-20 and others view this as the key goal for 2009. However, the proposals go much further. They would result in some of the most significant changes to the accounting model ever seen for banking institutions and would undermine the G-20's efforts to strengthen the financial system.

It also appears that the G-20's request for "the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards" has been largely ignored, as neither the FASB nor the IASB proposals meet the fundamental principles of the Basel Committee on Banking Supervision's "Guiding principles for the replacement of IAS 39."

It is our understanding that the IASB's effort to finalize its rules for year-end 2009 is based, in part, on the G-20 request that "the accounting standard setters should take action by the end of 2009." This is one recommendation set forth by the G-20 that may be met, but to the clear detriment of the remaining G-20 recommendations on accounting. We believe that the G-20 did not contemplate the massive changes being discussed by the FASB and IASB, and we recommend that the G-20 clarify that additional time for "due process" is essential. Additionally, if the G-20 has strong views that the accounting should reflect the business model, then providing that input to the standards setters could be useful.¹³ The G-20 may also want to consider asking the IASB and FASB to provide the G-20 with a summary of how their proposals measure against the G-20 recommendations prior to the G-20 meeting in Pittsburgh.¹⁴

While we agree with the recommendation that repairs be made by the end of 2009, we believe the focus should have been on loan loss provisioning. Requiring a new

end of 2009 that would make it more forward looking, as long as the transparency of financial statements is not compromised."

¹³ The Basel Committee on Banking Supervision has made its views known about the need for accounting to reflect the business model and that the new accounting rules should not result in expanding mark to market. For example, the Basel Committee on Banking Supervision's recommendations for changing the accounting model for financial instruments ("Guiding principles for the replacement of IAS 39", August 27, 2009) states:

- "Fair value should not be required for items which are managed on an amortized cost basis in accordance with the firm's business model."
- "The new two category approach should not result in an expansion of fair value accounting, in particular through profit and loss for institutions involved in credit intermediation. For example, lending instruments, including loans, should not end up in the fair value category."

¹⁴ The IASB is providing on its website an "Updated summary of IASB response to G20 recommendations" ("IASB/IASC Foundation Response to April 2009 G20 Recommendations, Strengthening Transparency and Accountability"). Although the document provides steps that have been taken, it does not provide information as to how its actions are fulfilling or will fulfill the recommendations.

accounting model for banking institutions that is as broad in scope as the models being discussed by the standard setters, and doing so in such a compressed time frame, will cause massive disruptions to the banking industry and to the economy.

Requiring banking institutions to follow mark to market accounting – simply because the nature of their business is financial – ignores the traditional bank business model and puts banks at a disadvantage. This is primarily because operating results would be based on the volatility of the marketplace rather than the cash flows that are received. Former Federal Reserve Chairman Paul Volcker noted that: “We need to question whether a naïve across-the-board application of mark-to-market accounting [is] suitable for regulated institutions.”¹⁵

The ABA has provided the attached letters and white papers to the FASB and IASB.¹⁶ We believe they provide a sound alternative approach that better reflects the business model used by banking institutions and improves information for users of financial statements.

As we were finalizing this letter, we were most encouraged to read the “G20 Banking Statement” of September 5, 2009, which states that the following action should be taken:

“Convergence towards a single set of high-quality, global, independent accounting standards on financial instruments, loan-loss provisioning, off-balance sheet exposures and the impairment and valuation of financial assets. Within the framework of the independent accounting standard setting process, the IASB is encouraged to take account of the Basel Committee guiding principles on IAS 39 and the report of the Financial Crisis Advisory Group; and its constitutional review should improve the involvement of stakeholders, including prudential regulators and the emerging markets.”¹⁷

However, it is clear that the proposals of the standard setters are at odds with this recommended action.

¹⁵ The Bottom Line, March 2009.

¹⁶ See attached Appendices: Appendix 3 is ABA’s letter to FASB and IASB on the accounting for loans and debt securities; Appendix 4 is ABA’s white paper, “Loans and Debt Securities: Principles to Follow in Developing a New Accounting Model”; Appendix 5 is ABA’s letter to FASB and IASB, expressing concerns about the process being followed; Appendix 6 is ABA’s white paper, “The Current Pace and Direction of Accounting Standard Setting.”

¹⁷ G-20: “Meeting of Finance Ministers and Central Bank Governors, London, 4-5 September 2009: Declaration on Further Steps to Strengthen the Financial System.”

We agree with the G-20 that a unified international solution – one that includes not only the IASB constituents but also the FASB constituents – is an important goal that should be achieved with a “joint project” between the FASB and IASB. However, currently the efforts of FASB and IASB are in conflict. We hope that you will consider our request to discuss these issues during the upcoming G-20 summit.

Sincerely,

A handwritten signature in black ink, appearing to read "Edward L. Yingling". The signature is written in a cursive, flowing style with some loops and flourishes.

Edward L. Yingling

Enclosures

G-20 Report: “Declaration on Strengthening the Financial System”, London, April 2, 2009.

Excerpts Relating to Accounting

- “[T]he FSB, BCBS, and CGFS, working with accounting standard setters, should take forward, with a deadline of end 2009, implementation of the recommendations published today to mitigate procyclicality, including a requirement for banks to build buffers of resources in good times that they can draw down when conditions deteriorate”
- “We also welcome the FSF recommendations on procyclicality that address accounting issues.”
- “We have agreed that the accounting standard setters should improve standards for the valuation of financial instruments based on their liquidity and investors’ holding horizons, while reaffirming the framework of fair value accounting.
- “We also welcome the FSF recommendations on procyclicality that address accounting issues. We have agreed that accounting standard setters should take action by the end of 2009 to:
 - reduce the complexity of accounting standards for financial instruments;
 - strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information;
 - improve accounting standards for provisioning, off-balance sheet exposures and valuation uncertainty;
 - achieve clarity and consistency in the application of valuation standards internationally, working with supervisors;
 - make significant progress towards a single set of high quality global accounting standards; and,
 - within the framework of the independent accounting standard setting process, improve involvement of stakeholders, including prudential regulators and emerging markets, through IASB’s constitutional review.”

APPENDIX 2

Quotes Regarding Proccyclical Accounting

Chairman Bernanke (Reuters, March 10, 2009): "Further review of accounting standards governing valuation and loss provisioning would be useful, and might result in modifications to the accounting rules that reduce their procyclical effects without compromising the goals of disclosure and transparency."

U.S. Department of the Treasury (Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation, June 2009): "...we urge the Financial Stability Board (FSB), BCBS, and the Committee on the Global Financial System (CGFS), in coordination with accounting standard setters, to implement by the end of 2009 the G-20's recommendations to mitigate procyclicality..."

Financial Stability Forum (Report of the Financial Stability Forum on Addressing Procyclicalities in the Financial System, April 2, 2009): "A number of developments in financial systems – including increased direct and embedded leverage, leverage funded with short-term debt, more marketable assets, and extensive application of fair value accounting – have contributed to an increase in the procyclicalities of the system."



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APPENDIX 3

August 4, 2009

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
301 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Sir David Tweedie
Chairman
International Accounting Standards Board
First Floor
30 Cannon Street
London, EC4M 6XH
United Kingdom

Re: Mark to Market for Financial Instruments

Dear Sirs,

The American Bankers Association¹ is deeply concerned about the direction being taken on the FASB and IASB “joint project” relating to recognition and measurement of financial instruments. The purpose of this letter is to provide you with principles that we believe should be followed for any new accounting model for loans and debt securities. Because these two types of assets represent a majority of the U.S. banking industry’s total assets, your actions are expected to have a major impact on the business of banking. We respectfully request that our industry be sought out as important sources of information and advisors on these projects. Based on the experience of our members’ interactions with investment analysts, as well as local investors in the thousands of community banks across the U.S., we believe our perspective reflects a “silent majority” among users of financial statements.

¹ ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation’s banking industry and strengthen America’s economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry’s \$14 trillion in assets and employ over 2 million men and women.

During the current economic crisis, preparers of financial statements, external auditors, regulators and others have agreed that “mark to market” accounting (MTM) estimates have lacked a sufficient level of reliability. With this experience, it is surprising that the IASB and FASB would both establish new accounting models that expand the use and prominence of MTM rather than either reduce it or at least maintain the current level.

The importance of transparent financial information cannot be overstated – but the models being considered by the FASB and the IASB do not improve transparency for our industry.

- The FASB’s model dramatically increases the use of MTM for financial institutions. The proposal would not only increase the use of it for measuring financial instruments – by requiring that virtually all financial instruments be marked to market on the balance sheet – but it also requires that the income statement provide, under the guise of Other Comprehensive Income (OCI), the full amount of MTM. This focus on MTM does not improve transparency for investors or other users in a banking institution’s financial statements because it is irrelevant to how the vast majority of banking institutions will receive the cash flows for the assets. If banking institutions are to be measured based on MTM, it could result in dramatic changes not only in the types of financial instruments used to manage traditional banks, but also in the products provided by banking institutions.
- The IASB’s model, if we understand it correctly, appears to be a more traditional model, but would require many more assets to be recorded at MTM. This model is clearly not as dramatic as the FASB’s model in its shift to MTM, but the classification criteria for MTM appear to arbitrarily target a large portion of the debt market.

While there is a degree of recognition in FASB’s tentative decisions as to the importance of an institution’s business model, both Boards’ tentative decisions emphasize MTM to an extreme,² which would imply to users that the business model of financial institutions is based on fair value. Because the entity’s results will be measured based on fair values, banking institutions will be expected to perform based on MTM.

We understand that certain investors and investment bankers who provide input to the Boards advocate MTM; however, accounting rules should address a wide variety of users and provide information that is relevant to generating cash flows and determining the prospect for generating future cash flows. Therefore, bankers have

² A component of this is the effort to require that OCI be presented on the face of the income statement, which the FASB has tentatively decided to do as part of this project on financial instruments, and the IASB is actively considering as part of another joint project with the FASB (“Financial Statement Presentation”).

consistently advocated that, in contrast to a “one-size fits all” model that is emphasized by pro-cyclical MTM, accounting for loans and debt securities held at banking institutions should reflect the applicable business models used by bankers.

Key features of this concept and important points for considering a change in the current model include the following:

- Segments of an entity that originate and buy loans and securities to sell or securitize, as well as trade for profit, should use MTM through earnings.
- Segments that utilize a traditional banking business strategy should use amortized cost to account for loans and securities. Any changes in fair values of assets should be disclosed in the footnotes.
- Accounting rules should be consistently applied to the business model during business combinations, as well as when assets are credit-impaired at the time of acquisition.
- Current tainting rules that cause portfolios to use MTM should be discontinued. Appropriate disclosures of portfolio management strategies and sales activity should be required.
- Loss provisions for loans and securities can be based on expected losses. However, the objectives, necessary processes and documentation requirements must be made clear and should reflect how bankers evaluate credit risk.
- Enhancing the current incurred loss models, which may provide the smoothest and most expedient transition, should be considered.
- Any changes to the loss provisioning models should be field tested prior to implementation, and sufficient transition time must be provided.
- Fair values in distressed markets for assets in the traditional banking model should reflect equal weighting between the prices a willing buyer and a willing seller would accept.
- Regulatory accounting rules should be consistent with GAAP.
- Accounting changes must meet a “costs vs. benefits” test.

The above bullets articulate that accounting for loans and debt securities should be based on how a company manages its business, with any changes to the accounting standards being carefully planned and implemented within the traditional timeframes. Portions of the business that are managed to maximize current fair values should use MTM; those that manage cash flows should use amortized cost, accompanied by a robust impairment process, which includes recording impairment based on expected losses over a horizon that can be reasonably estimated. This is how the vast majority of these companies is managed and will provide an improved basis for understanding these companies’ performance.

It is also important that the FASB and IASB consider issues that, to our knowledge, have either not been addressed or arise due to the tentative decisions made thus far.

For example:

- What is the logic of accounting for financial instruments at market value, but not using MTM as the model for all industries?³
- From a conceptual perspective, why should unrealized market value gains and losses on assets being held for long-term purposes be reflected in a statement of performance when realization of such gains and losses conflicts with the business model and are not expected to occur?
- From an audit perspective, what amounts and forms of additional documentation would be required to determine the market values of individual loans or portfolios of loans? Will third-party verification be required, as is currently being required for other debt instruments?
- What will the impact be in the markets and on the cost of capital for financial institutions versus other types of industries that are not subject to MTM?
- What will the impact be on products provided by financial institutions?
- Given the majority of banking institutions in the U.S. have under \$500 million in assets, are community-based, and operate a traditional banking business model, will such accounting changes induce burdens that will cause these entities to reconsider participation in certain types of instruments or markets?

These critical issues, especially in today's economic environment, must be evaluated. The attached paper, "Loans and Debt Securities – Principles to Follow in Developing a New Accounting Model", provides additional information about the accounting for loans and debt securities. Again, we urge you to work with our industry as you continue your efforts to improve the accounting for financial instruments. We share that same important goal. Please contact either Mike Gullette (202-663-4986; mgullette@aba.com) or me if you would like to discuss our views.

Sincerely,



Donna Fisher

Enclosure

³ The ABA is not proposing that MTM be used for the entire balance sheet. However, the use of MTM solely for financial instruments, particularly those that are not traded or intended to be sold, should be evaluated against the use of MTM more broadly.

Loans and Debt Securities

Principles to Follow in Developing a New Accounting Model

American Bankers Association

August 2009

Contact: Michael L. Gullette
VP, Accounting and Financial Management
202-663-4986
mgullette@aba.com

**Loans and Debt Securities
Principles to Follow in Developing a New Accounting Model
American Bankers Association
August 2009**

EXECUTIVE SUMMARY

Accounting rules should address a wide variety of users and provide information that is relevant to evaluating an institution's success at generating cash flows and determining the prospect for generating future cash flows. Therefore, bankers have consistently advocated that, in contrast to a one-size fits all model that is emphasized by pro-cyclical mark-to-market accounting (MTM), accounting for loans and debt securities should reflect the applicable business models used by bankers. Key features of this concept and guidance for changing the accounting model include:

- Segments of an entity that originate or buy loans and securities to sell or securitize, as well as trade for profit, should use MTM through earnings.
- Segments that utilize a traditional banking business strategy should use amortized cost to account for loans and securities. Any changes in fair values of assets should be disclosed in the footnotes.
- Accounting rules should be consistently applied to the business model during business combinations, as well as when assets are credit-impaired at the time of acquisition.
- Current tainting rules that cause portfolios to use MTM should be discontinued. Appropriate disclosures of portfolio management strategies and sales activity should be required.
- Loss provisions for loans and securities can be based on expected losses. However, the objectives, necessary processes and documentation requirements must be made clear and should reflect how bankers evaluate credit risk.
- Enhancing the current incurred loss models, which may provide the smoothest and most expedient transition, should be considered.
- Any changes to the loss provisioning models should be field tested prior to implementation, and sufficient transition time must be provided.
- Fair values in distressed markets for assets in the traditional banking model should reflect equal weighting between the prices a willing buyer and a willing seller would accept.
- Regulatory accounting rules should be consistent with GAAP.
- Accounting changes must meet a "costs vs. benefits" test.

KEY DISCUSSION POINTS

Accounting Must Satisfy a Broad Range of Users, Not Just Those Who Like Mark-to-Market

Accounting for loans and debt securities is at the heart of many recent accounting standards relating to banking institutions. Since 1995, accounting for debt securities has revolved around mark-to-market accounting (MTM), where financial results of banking enterprises are largely dependent on the fair values of these instruments.

For decades, bankers, while supporting MTM for specific elements of a bank's operations, have generally opposed MTM, because information derived by MTM is irrelevant to the general business objectives of a traditional banking enterprise. This is in contrast to continued efforts by the FASB and IASB to increase MTM over all aspects of banking financial statements. These boards claim that the large institutional investor is their main customer, and that investors insist on MTM.

Bankers, however, believe that financial statements should address concerns of a larger audience, which includes depositors, local investors of community banks, regulators, as well as management. In other words, financial statements should reflect concerns of a broader audience that is not necessarily concerned with the short-term profits that many institutional investment managers must address. Financial statements, and the underlying accounting, should provide utility for a broad range of purposes and users.

Accounting Should Reflect the Business Model: MTM for Trading-driven Segments, Amortized Cost for Traditional Banking Operations

As they have for years, bankers advocate accounting principles that reflect how banking institutions direct their enterprises. This is the highest and best use of financial statements, as it provides users of financial statements with information about how the assets and liabilities are being managed. In other words, for a bank or a segment of a bank that buys and sells loans and securities for profit, MTM is appropriate since it provides a better estimate of the cash flows it generates than would an accounting model based on amortized cost. For segments of the bank that manage interest income and interest expense spreads (the traditional banking segment), MTM is not appropriate. With this in mind, an appropriate accounting model for banking institutions includes the following:

- Segments of an entity that originate or buy loans and securities to sell or securitize (they may refer to this segment as a wholesale lending operation), as well as trade for profit, generally should be subject to MTM, with changes in value within an active market immediately recorded through earnings.
- Segments that utilize a traditional banking strategy, with earnings based on interest income and interest expense spreads, should be subject to an amortized cost accounting model.
- Contrary to current accounting rules, these accounting models should be consistently applied, including accounting for business combinations and when assets are credit-impaired at the time of acquisition.

Maintaining amortized cost valuations for loans and securities in the traditional banking segment gives investors a simple and accurate way to view how the organization manages its portfolio. The

investor can easily see what amounts are due to the bank, how much is expected to actually be collected, and what level of yields are being earned.

A business model based on interest spreads does not require the “held-to-maturity” classification that currently exists. Since the accounting is based on business model and not on “management intent”, the current auditing procedure effects of “tainting” a portfolio by requiring MTM for similar sales of securities is not a relevant concept. While traditional banks manage portfolios for long-term margins, sales out of a portfolio occur normally to rebalance and match, based on weighted average credit and market risks (duration, for example), the assets and the funding liabilities within the portfolio. This traditional banking management process has been hampered by the current accounting rules. Adequate disclosure of portfolio activity will provide additional insight as to portfolio quality. For example, full disclosure of unrealized gains and losses allows users of financial statements to determine whether “cherry picking for gains” is practiced.

No “One Size Fits All”: Accounting Should Reflect the Objectives of Each Aspect of the Business

Any model that attempts to provide a “one size fits all” approach to loans and securities provides irrelevant information about a business entity, and therefore, greatly reduces the usefulness of such information to investors. As a critical responsibility assumed in equity ownership is to hire and evaluate the performance of company management, applying a model such as MTM across the whole organization makes this task almost impossible if the business objectives do not align with the accounting. This is why bankers believe that the traditional banking operations should record loans and securities using amortized cost. It is not because “fair values” are necessarily inaccurate. It is because market values are not relevant to the cash flows banks attempt to generate. Therefore, measuring fair values of loans and securities managed in this business model should be reflected only in the footnotes and not recorded in the Income Statement or the Statement of Other Comprehensive Income. Such changes in fair values are not expected to result in cash flows to the organization and management will not normally execute strategies in reaction to these changes in market price.

Further, “fair value” measurements used for balance sheet purposes (for selling operations) or for disclosure (for traditional banking operations) should also avoid the “one size fits all”. The “exit value” concept for fair value measurement is appropriate for the selling operation. For the traditional banking operation, however, since there is normally no intent on selling the security, fair value measurement in distressed markets should reflect executable transactions and give equal weight of the price a willing seller would accept as well as the willing buyer. Exit prices are irrelevant to these operations, so such values would normally exclude discounts now applied due to the lack of current liquidity in the market.

Impairment: Accounting Rules May Be Based on Expected Losses, Though Requirements Should be Clear and Reflect How Bankers Evaluate Credit Risk

Bankers understand the need to measure impairment (recording losses on loans and securities) based on expected losses. This is generally how some banks viewed their loan loss reserves until the last decade. Efforts by the SEC and the FASB to re-define “incurred” losses, including questions around the analysis and documentation of events that cause losses, have generally limited loan loss

allowances that have already been incurred, but may not be specifically identified, to a fairly short future period (in some cases, only twelve months).¹

Bankers, consistent with their management of periodic net investment spreads, generally support recognizing losses earlier than the current practice, which produces a more consistent net yield recognized on a year-to-year basis. Bankers also believe further use of judgment in determining and defining loss events will lead to reserves that more accurately reflect management's experience in evaluating credit risk. For example, a change in management at a debtor company may not currently qualify as a loss event. However, experienced bank lending officers may believe extra loan loss provisions may be required, based on their knowledge of the industry.

With that said, expected loss provisioning is currently not well defined. For example, "expected loss" could mean losses over a horizon that can be reasonably estimated; it could mean losses expected throughout the life of a loan or a portfolio of loans, etc. Prior to reaching agreement on an expected loss model, the objectives of expected loss provisioning must be made clear to both financial statement preparers and users, with the accompanying presentational and operational implications understood. Users must be educated as to what the loss provisions represent and do not represent.

It should be noted that significant operational challenges with using specific expected cash flows (such as addressing the specific timing of loan payments and the effect of interest rate changes among specific products and borrower classes) make such proposals daunting, and would require major systems changes and assumption frameworks that are not currently used.

As opposed to adopting a significantly different model addressing expected losses, some believe that enhancing the current incurred loss model may be the most operational and understandable approach. Merely expanding the consideration of factors that require provisioning could result in a more realistic method of provisioning than current practice. However, if further changes to the accounting model are anticipated, bankers understandably prefer to make systems changes only once. So, any changes must be made with the ultimate objectives in mind. If improving the current model is the approach taken, providing for additional general reserves or "environmental factors" may be viable. However, the requirements must be clear as to what these estimates are intended to represent (losses embedded in pricing assumptions, losses with an expectation of how the economy is projected to perform over the coming years, etc.) and how they must be documented and supported by management.

No matter the specific requirements, significant education of users will be necessary on any change. Further, field testing will be necessary, particularly if the change is significantly different from current practice or adds complexity from a systems perspective. For example, bank lending departments do not normally perform detailed expected cash flow analyses for all individual loans in a portfolio, and such estimates that are currently performed for impaired loans are often manually intensive. In contrast to how amortized cost accounting reflects the way banks view their business, bankers are wary of performing valuations that do not reflect how their lending departments analyze credit risk.

¹ It is for this reason that we recommend an appropriate transition period. See section: *Transition: An Appropriate Transition Period Must be Provided.*

Transition: An Appropriate Transition Period Must be Provided

Although the primary accounting standard for calculating loan loss reserves has been in place since 1975, SEC and FASB interpretations over the past decade have resulted in a lower level of reserves than many bankers believe the original rules required. Therefore, any move to a new loss provisioning model may result in a significant increase in reserves. Provision should be made to transition to the new reserve levels over a reasonable period of time, also allowing for time to implement new systems required to capture and process data under the new requirements.

Accounting Changes Must Meet a Costs vs. Benefits Test

An important part of the accounting rule-makers' process must include an evaluation of expected costs of compliance versus the benefits to be derived by the various users of the financial statements. This evaluation should include, but should not be limited to, consideration of the costs and the time involved to implement, execute, and maintain systems that must produce new information and supporting documentation, all while complying with already-tight regulatory deadlines. These processes, which may require additional internal control procedures, audit fees, and third party preparation fees, must be weighed against the relevance and reliability of the information to the main users of this information. Any change should be also evaluated based on its effects on financial statement volatility (and related cost of capital increases), as well as pro-cyclicality on the general economy.

DETAILED DISCUSSION

Mark to Market Accounting: Historical Context

Accounting for loans and debt securities is at the heart of the mark-to-market accounting (MTM) issue. While the issue came to a head during the Financial Crisis of 2007-2009, the issue has been highly debated over a long period of time. FASB Statement No. 115, *Accounting for Certain Debt and Equity Securities* (FAS 115), issued in 1993, is the standard that requires MTM for debt securities. FASB Statement No. 157, *Fair Value Measurements* (FAS 157), re-defined “fair value” (estimates of MTM), emphasizing an “exit price” to determine fair value, and established a hierarchy for determining fair value.

The MTM controversy, however, began long before the issuance of FAS 115. Contrary to claims by many supporters of MTM, bankers do not advocate the total abolition of MTM. Bankers also do not “enjoy” MTM “when markets are good”. The following is a timeline of just a few documents published over the years **prior to this financial crisis** where bankers or banking regulators have provided feedback that was critical of MTM.

1938	Comptroller of the Currency revises bank examination procedures from market value to intrinsic value – MTM is suspended for regulatory purposes.
1990	Federal banking regulators, in <i>Study of the Merits of Market Value Accounting for Certain International Debt Exposures</i> , cite “likely volatility in...banks’ reported financial position” and MTM “could have a significant adverse effect on the safety and soundness of the banking system.”
1990	American Bankers Association, in <i>Market Value Accounting</i> , cites that MTM is “subjective, volatile, and unreliable” causing information to be “volatile and potentially misleading”.
1999	Joint Working Group of Banking Association, an international group established by the predecessor to the International Banking Federation’s Accounting Working Group, publishes a paper noting “A full fair value system does not provide a sound basis for predicting banking book net cash flows and lacks relevance... fair values for banking operations would reduce both the reliability and the comparability of financial statements”.

Coinciding with each of these arguments, bankers have also pointed out that unnecessary volatility is introduced into bank financial statements because of MTM – misrepresenting cash flows. During the current financial crisis, the result of this volatility is referred to in economic terms: pro-cyclicality. Volatile market prices drive up risk premiums, forcing down prices and reducing capital, thereby restraining bank lending. As lending is reduced, economic growth is stifled, further resulting in delinquencies and defaults – the very events that started the cycle.

Even before the financial crisis, MTM has been a source of contention between accounting rule-makers and bankers. With this in mind, it is useful to understand that bankers’ opposition to MTM has been consistent and, as can be seen below, based on the very foundational accounting concepts upon which FASB itself has established.

Financial Reporting Should Address Various Potential Users of the Financial Statements

In order to construct an appropriate accounting model, bankers and accounting rule-makers must both understand and adhere to the objectives as noted in the FASB's Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises* (CON 1; issued in 1978 and still in effect). Among other things, CON 1 notes:

“Financial reporting should provide information to help **present and potential investors and creditors and other users** in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors' and creditors' cash flows are related to enterprise cash flows, **financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.**” (Emphasis added)

While there can be a wide interpretation of what “other users” in the previous paragraph may mean, CON 1 further develops that notion:

“Among the potential users are owners, lenders, suppliers, potential investors and creditors, employees, management, directors, customers, financial analysts and advisors, brokers, underwriters, stock exchanges, lawyers, economists, taxing authorities, regulatory authorities, legislators, financial press and reporting agencies, labor unions, trade associations, business researchers, teachers and students, and the public.”

Understanding that each of these users will have different levels of technical accounting knowledge as well as different interests in the financial statements of the bank, it is important that accounting rule-makers understand that the financial statements are, as CON 1 notes “directed toward the **common interest** of various potential users...” (Emphasis added)

It is understandable that, since the Securities and Exchange Commission delegates accounting rulemaking authority to the FASB, the large public investor is normally considered the FASB's main “customer”. This can create and maintain bias toward accounting principles and disclosures that are inappropriate for the many users of bank financial statements. Given the ever-changing metrics that have evolved over the past twenty years from investment analysts, in an attempt to satisfy its customers, it is important for FASB to differentiate “transparency” in financial reporting from “noise” that merely confuses the user. With this in mind, FASB must take CON 1 into consideration regarding: 1) who the users of the financial statements are, and 2) how the objectives of accounting are geared toward the common interest of **all** financial statement users.

Financial Reporting Should Be the Same for Investors and Regulators

Various people advocate the acceptance, and even the desirability, of accounting principles used for financial reporting purposes to be different from those used by regulators for safety and soundness purposes. Supporters believe that regulatory accounting can be as flexible as needed to better reflect the perceived risk to the depositor system or taxpayer in general. Although there can be situations when this is the case, this perspective ignores significant realities. First, differences in GAAP and Regulatory Accounting Procedures (RAP) were highly criticized – particularly in the loan accounting

area – subsequent to the Thrift Crisis. In fact, in addition to lax capital requirements on thrifts at the time, regulatory forbearance allowed significant elements of GAAP to be suspended or changed among certain institutions. It is significant that, in reaction to this, regulations enacted through the Federal Deposit Insurance Corporation Improvement Act of 1991 closed the differences between GAAP and RAP.

Second, a RAP to GAAP difference may add confusion to the stakeholders of a banking institution, as well as the safety and soundness of the deposit system in general. Most stakeholders in a banking institution are not common shareholders, but are depositors who rely on reported operating results and changes in capital. Bankers believe it is critical to continually improve GAAP while keeping regulatory accounting the same as GAAP. Once improvements are made, banking agencies may adjust their regulatory capital rules (amounts of capital required), based on their perspectives of risk. However, the first step should be to improve GAAP.

Overarching Principle of Accounting: Accounting Should Reflect the Business Model

As CON 1 notes, “financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise”. Therefore, accounting for financial instruments should reflect the organization’s business model, since the business model drives how the enterprise will realize its cash flows.

Most banking institutions have diversified operations: certain segments operate on a basis of maximizing current values and investment gains; other segments operate on a traditional banking strategy of managing interest income and expense spreads. Accounting should reflect these very different objectives. To use a single model (for example, fair value only or amortized cost only) based on the characteristics of the financial instrument will mislead and confuse all users of the financial statements by including information irrelevant to how the enterprise generates cash flows. Not only will they not understand how future cash flows of the enterprise will be derived, but also whether management has effectively managed them in the past.

In the past, FASB recognized this in its accounting standards relating to mortgage banking (FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*), with a two-bucket approach to measuring loans based on management intent. Additionally, FAS 115 carried forward this concept of business intent with its three-bucket approach for measuring debt securities based on management intent. However, the evolution in practice for FAS 115, with strict tainting penalties and impairment rules, has resulted in an environment where intent and business model are often unrelated. Traditional bankers are often forced to MTM certain securities, even though they have no plans to sell the securities. The tainting concept, which has been applied by auditors, could cause a bank’s portfolio to be subject to MTM simply by selling a security – even if it is a legitimate part of the bank’s asset/liability management process. Thus, FAS 115 is often dictating business decisions, instead of reflecting them.

MTM is Appropriate for Selling Operations, Amortized Cost for Traditional Banking Operations

For segments of the bank that buy and sell loans for profit, MTM is appropriate. Such segments commonly include wholesale mortgage banking operations (consisting of originating loans and selling them to secondary market buyers, often through a securitization process), market-making operations (buying and selling of mortgages and securities for retail customers) and trading operations (buying and selling for profit). The fair value of the related loans and securities are critical and indicative of the ability of the segment to generate future profits.

In contrast, traditional banking operations are not dependent on, nor managed to maximize, current fair values of their investment holdings. Put simply, this segment of a bank manages cash flows – deposit liabilities typically providing funds for loans and securities that are held long-term for the purpose of earning interest margin spread. With this in mind, traditional banking operations record and value assets based on what provides a relevant indication of future cash flows – amortized cost.

Amortized cost valuations generally represent the unpaid principal balance of a loan, adjusted for net origination fees and purchase premiums and discounts. In other words, amortized cost approximates the principal cash flows that a banker is owed.

Amortized cost accounting not only provides an accurate and easy-to-understand indicator of future cash flows and yield, when it is accompanied by a robust impairment accounting model, it effectively provides investors with the net amounts expected to be collected. The amortized cost model provides the investor with an “insiders’ view” – management’s view – of these investments.

There has been much discussion about heightening the level of importance of MTM information for traditional banking operations by including non-credit portions of MTM as a component of income in the financial statements. Bankers believe this would be a mistake. As traditional banking operations focus on current and future cash flows, changes in fair values are not primary drivers of investment decisions. While fair values can signal changes to future cash flow expectations, bankers generally do not react to fair value changes by selling their holdings. Changes in funding strategies and future underwriting standards are among the options bankers have in managing the cash flows and overall risk in their business portfolios. Fair values also cannot accurately reflect knowledge known only through a bank’s close relationship to the borrower. In other words, cash flows are managed over time and through a number of channels. Traditional bankers do not manage to fair value and do not plan and execute strategies to directly maximize fair values.

Therefore, any requirement to record fair value changes for loans or securities in the traditional banking operation through the Income Statement or through the Statement of Other Comprehensive Income (OCI) will provide irrelevant information to the financial statement user. Even entries to OCI erroneously create an expectation in the user that such changes are expected to be realized in the future. This is why amortized cost accounting, when supplemented with a robust impairment and disclosure process, is the best measure for recording asset values, and heightening the level of importance of MTM, by increasing its use in the Income Statement or amplifying it within OCI, would be a mistake.

This amortized cost model should also be applied in all circumstances within the business model. Current rules require different accounting when loans are involved in a business combination or are

impaired at purchase (Per FASB Statement 141R, *Business Combinations*, loans involved in a combination and not individually identified as impaired are recorded at fair value, with any previously recorded loan loss reserves to be eliminated. Per AICPA Statement of Position 03-3, *Accounting for Certain Loans and Debt Securities Acquired in a Transfer*, purchased impaired loans are recorded at fair value upon purchase, with prospective cash flow projections to be performed on an ongoing basis). Therefore, loan loss allowances on a specific loan or security currently differ based on when it was acquired by the bank and whether specific impairment had been identified prior to the acquisition. These rules are confusing to investors, add significant operational challenges, and reflect processes foreign to bank lending departments. Even at their best, because of these pronouncements, the definition of “impairment” becomes blurred, confusing users, who still desire delinquency and charge-off data.

Accounting Rules Should Be Consistently Applied to the Business Model During Business Combinations and When Assets are Credit-impaired at Acquisition

In light of recent banking mergers, these two rules (SFAS 141R and SOP 03-3) are helping to demonstrate that MTM for loans does not reflect cash flows, as large discounts at acquisition are being recognized into income at yields that have no relation to their note rates. Understanding loan balances and reserves is critical to understanding the business model. Estimating the fair value of credit risk presents practical problems that underlie the fair value measurement of debt instruments in general and put the reliability of such fair values into question. First, underwriting standards and lending departments at banks are not based on MTM. Instead, banks continuously focus on the borrower’s ability to repay cash flows. This calls into question the usefulness of MTM estimates. Further, an efficient market that accurately prices credit risk has not been demonstrated, calling into question the reliability of MTM estimates.

With this in mind, bankers believe, in context of the traditional banking strategy, that more reliable and relevant information can be provided to users of banking institution financial statements by valuing these loans and securities at their amortized cost, with an adjustment only for interest rate-related market valuation. A separate allowance for loan losses would be carried forward and maintained.

Tainting “Rules” Must Be Discontinued

Amortized cost is the measurement basis for specifically designated securities. However, audit penalties related to “tainting” a portfolio (requiring the whole portfolio to be designated for MTM) have made the use of amortized cost almost impossible for some banks. The threat of tainting results in banks making decisions that are in conflict with how they normally manage their portfolios. While banks intend to hold their loans and securities for the foreseeable future, changes in the economic environment and credit characteristics of their portfolios will result in the need to realign their portfolios and sell (or buy) some investments. Thus, some banks have difficulty affirming that they will hold these investments to maturity, and this forces many securities out of amortized cost accounting and into MTM. Therefore, an appropriate amortized cost accounting model must also eliminate the arbitrary tainting practices that end up driving, and not reflecting, business decisions. Bankers believe that detailed disclosures on sales of their investments provide investors with better information on how credit and market risks are managed.

Impairment on Loans and Securities Should Reflect Expected Losses as Estimated by Management; However, Reporting Objectives and Requirements Must Be Clear

■ *Most “Expected Cash Flow” Methods are Cumbersome and Not Based on Business Processes*

Bankers estimate losses based on a variety of models: current delinquencies, projected delinquency migration, expected income and collateral values, historical experience, and other factors. However, the specific timing of cash flows is not regularly estimated on a portfolio basis, but on an exception basis, and generally relate to credit impairments. This process is often manually intensive. Therefore, in context of proposals to estimate losses based on “expected cash flows”, which would require that the amounts and specific timing of all expected future cash flows be estimated for all such assets, such processes would be particularly onerous to execute for the entirety of loans and securities in banks’ portfolios. Such estimates, which often must involve projections of interest rates and prepayments, are not performed in typical lending departments and would be executed exclusively for accounting purposes. Performing such calculations at an aggregate portfolio level, which will be necessary at many banks, also subjects an organization to substantial modeling risk in the short term and may also introduce inaccurate volatility from quarter to quarter (aggregation would include, at a minimum, stratification of products, underwriting criteria, issue dates, etc.).

■ *Loan Loss Reserves Should be Based on Expected Losses that are Understandable and Operational*

Banking institutions normally price their products and services (or invest in securities and businesses) to reflect risk and for ultimate expected margins (resulting from net investment yields over their cost of funds) across a segment or total portfolio. Granted, loans may result in different yields than anticipated. However, these factors lead to the notion that reserving for expected losses over a horizon for which losses can be reasonably estimated is consistent with the traditional banking business model. There are conceptual and operational issues, however, that must be addressed prior to implementing such an accounting model. For example, if the objective is to reflect the amount of loss expected over the life of a specific book of loans (a “balance sheet” approach), then reserves, and consequentially, loss provision expenses would be required to be recorded upon initial issuance of a loan. This approach will be confusing to virtually all users of financial statements, it would put at a disadvantage those organizations with growing books of business, and could create a timing of losses recognition that is overly front-loaded.

If the objective is to reflect a net yield earned over time, with a portion of an instrument’s interest income set aside for ultimate losses (an income statement approach), the operational challenges to financial statement preparers of creditors are vast, as noted above. Recent experience with accounting for loans under the AICPA Statement of Position 03-3 and the FASB’s new standard on business combinations has resulted in confusion with investors about how to evaluate losses.

Bankers believe that any impairment model, including an expected cash flow model, should address only the principal loss, as opposed to lost interest that is inherent in cash flow expectations. Impairment is intended to measure principal impairment rather than future income potential.

Because of the operational and educational issues associated with an expected cash flow model for loss reserving, some believe consideration should be given to enhancing the current incurred loss

model as the solution for loss provisioning. For example, the 2006 Interagency Policy Statement on Allowance for Loan and Lease Losses (issued by the federal banking regulators) points out factors to consider in determining loss reserve estimates. One factor, “Changes in international, national, regional, and local economic and business conditions and developments that affect the collectability of the portfolio, including the condition of various market segments,” can be interpreted to specifically address the concern that losses are being recorded too late. Although this guidance is currently in effect, in practice it is unclear how such factors should be considered, how they can be factored into measurement of the loss, and what documentation is required. Evidence of such judgment, via documentation that is acceptable to external auditors, is difficult to produce. Allowing such factors, and expanding other “forward-looking” factors, to be documented and measured at the macro-level of a portfolio as general adjustments for the expected loss, will be operationally attractive and understandable. It must be made clear to both preparers and users of financial statements, however, what these reserves represent. Further, detailed guidance is critical on how these estimates must be documented and supported by management during an audit.

Fair Value Measurements

The current “exit price” notion of FAS 157 is applicable to the selling/trading business (or to instruments that are accounted for under the Fair Value Option), no matter the level of market activity. However, distressed sales are not to be used unless that is the market in which the assets are expected to be sold. Since the seller/traders manage their business each day based on fair values, an exit price notion is appropriate (assuming a liquid market and frequent trading).

For the purposes of disclosing the fair values of interest spread assets (those in the traditional banking model), however, an exit price is not normally appropriate, because these assets are not managed for fair value, but for the cash flows that are expected. In inactive/dislocated markets, modeled values should reflect prices that are actually executable and must put equal weighting to the prices both willing buyers and willing sellers would accept in a non-distressed transaction. This price should normally exclude any discounts that are applied due to lack of liquidity in the current market.

Accounting Changes Must Meet a Costs vs. Benefits Test

A “costs versus benefits” analysis is recognized by the FASB and IASB as an important component of due process.² Any change in the accounting for financial instruments should include an analysis of the costs to implement and maintain new systems, the incremental time to prepare the information and supporting documentation in compliance with internal control requirements, incremental audit and third party preparation fees, and whether implementing the new accounting

² Included in the mission of the FASB is the following: “*To promulgate standards only when the expected benefits exceed the perceived costs.* While reliable, quantitative cost-benefit calculations are seldom possible, the Board strives to determine that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits.”

Included in the IASB’s *Due Process Handbook* (April 2006): “The IASB weighs cost/benefit considerations as a part of its deliberation, although a formal quantitative assessment of the costs and benefits is not practicable. The IASB notes that there is still a lack of sufficiently well-established and reliable techniques for quantitative cost/benefit analyses in the fields of policy for which the IASB is competent. The IASB gains insight on the costs and benefits of standards through its consultations, both via consultative publications (discussion papers, exposure drafts etc) and communications with interested parties (liaison activities, meetings etc). The IASB’s views on cost/benefit questions are reflected explicitly in the basis for conclusions published with each exposure draft and IFRS.”

standards will impede timely public reporting. The reliability of the information being requested and its relevance to the main users of the banking institution's financial statements must be examined. These are issues that banks, both large and small, will likely face as they prepare for a major change to the accounting standards.

If a MTM model is used for financial instruments – and not for other types of assets and liabilities held by entities in other industries – then an analysis as to why such a shift is necessary would be useful. Since most banking institutions operate on a traditional banking business model, however, the consequences of any shift from the existing foundation of measuring banks based on their business model versus measuring banks based on MTM should be analyzed. For example, an analysis should be performed to determine whether the increased volatility resulting from the use of a MTM model for financial institutions – and not for other types of industries – will result in a differential in the cost of capital and a resulting change in product mix. In certain cases, the costs of compliance – determining quarterly market values on specific debt securities that will be held for the foreseeable future is an example – can cause some institutions to reconsider whether participation in certain markets is worth the cost.

Since the vast majority of banks in the United States are, by institutional investor standards, small and relatively closely held, accounting standards must also not place undue operational burdens on or hamper the proper management of these entities. Over 80 percent of banking institutions in the United States have total assets of less than \$500 million. Compliance with new accounting standards naturally has a larger impact on these smaller banks. Since they do not manage to fair value, these organizations do not normally possess the in-house systems and personnel to perform in-house modeling that is required when markets are illiquid. For example, external services to perform such MTM estimates (under the current MTM rules) have recently been quoted at up to \$3,000 per security. Each expansion of MTM places undue burdens on these organizations, and may result in a change in the types of instruments used for managing cash flows at smaller banks.

Conclusion

Accounting for loans and debt securities should be based on how a company manages its business. Portions of the business that are managed to maximize current fair values should use MTM; those that manage cash flows should use amortized cost, accompanied by a robust impairment process, which includes recording impairment based on expected losses over a horizon that can be reasonably estimated. This is the path that the accounting rule makers should take, as it will provide an improved basis for understanding a company's performance



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APPENDIX 5

August 12, 2009

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Sir David Tweedie
Chairman
International Accounting Standards Board
First Floor, 30 Cannon Street
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United Kingdom

Re: The Current Pace and Direction of Accounting Standard Setting

Dear Sirs,

The American Bankers Association¹ is concerned about the process being taken on the FASB and IASB projects relating to financial instruments. The changes that the FASB and IASB are considering represent the most significant accounting changes we have ever experienced. We encourage the FASB and IASB to make such changes only with utmost caution and the appropriate level of due process to correspond with the magnitude of the changes. The purpose of this letter is to provide you with our views about the process and provide recommendations for the Boards to consider.

Although we agree that a certain amount of change is urgently needed, the FASB and IASB direction may cause significant disruption, with both preparers and users of financial statements. Rule-makers must be very careful in this effort to ensure that any changes: 1) represent solid and meaningful change that is valuable and understandable to financial statement users; 2) focus on the business models used by

¹ ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$14 trillion in assets and employ over 2 million men and women.

entities that prepare the financial statements, and 3) can be implemented and maintained at a reasonable cost.

The rapid paces at which both organizations are working, as well as the paths being taken, are causing some to question whether there is due process in evaluating these important issues. Some bankers also question whether such efforts are driven by a search for simplicity, transparency, and accuracy or by an appetite to expand fair value accounting, no matter the implications.

A major concern is that the current directions in which the FASB and IASB are moving appear to be similarly requiring more mark to market accounting (MTM) within the financial statements, more capital for many existing banking activities, and more operational challenges to comply with these rules for banks of all sizes. The cost of accounting compliance puts continued participation in certain market activities at risk for some smaller institutions.

Another concern is the current divergence between the FASB and IASB proposed models and time frames for completion. The IASB plans to finalize its accounting standard in 2009, and the FASB's completion date will be subsequent to that date. In such case, the FASB will have only one of two choices: (1) to follow the IASB model – which will not provide U.S. companies with appropriate due process for providing input, or (2) a lack of international convergence – which should be avoided. Also related to this is that the IASB appears to be solving the accounting puzzle on a piecemeal basis, which may result in pre-determining the outcome for subsequent parts of the puzzle that may not fit.

We recognize that the FASB and IASB are under some pressure to finalize their rules quickly; however, we do not believe this should be at the expense of undermining the foundations of financial reporting – which could be the case with these dramatic changes. It is extremely important that these new standards be developed jointly by the FASB and IASB, with proper due process and open consultation with a wide range of constituents that ensures a holistic review.

Additionally, as noted in our letter to the FASB and IASB (dated August 4, 2009), the following points should also be considered when making substantial changes to the accounting model:

- Serious consideration must be given to field testing proposals prior to implementation, and sufficient transition time must be provided.
- Regulatory accounting rules should be consistent with GAAP.
- Accounting changes must meet a “costs vs. benefits” test.

Attached is our paper, which provides additional information about our views. Please contact either Mike Gullette (202-663-4986; mgullette@aba.com) or me if you would like to discuss our views.

Sincerely,



Donna Fisher
Enclosure

The Current Pace and Direction of Accounting Standard Setting

A White Paper of the

AMERICAN BANKERS ASSOCIATION

ABA Contact:

Michael L. Gullette

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The Current Pace and Direction of Accounting Standard Setting

Summary

Various high profile groups have studied the financial crisis and its root causes. In each case, accounting standards, while not being cited as causing the crisis, have been cited for improvement. Fair value accounting (“FV”, also called “mark-to-market accounting” or “MTM”) and reserving for credit losses are accounting standards that are most often cited (particularly relating to pro-cyclicality), along with off-balance sheet vehicles.

Both the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”) are addressing these issues (See Appendix B). The rapid paces at which both organizations are working, as well as the directions in which they are heading, are causing some to question whether there is due process in evaluating these important issues. Some bankers also question whether such efforts are driven by a search for simplicity, transparency, and accuracy or by an appetite to expand fair value accounting, no matter the implications.

One banker described the paths being taken by the FASB and IASB as representing “the most significant accounting changes we have ever experienced.” Although we agree that change is urgently needed, the FASB and IASB direction may cause significant disruption. Rule-makers must be very careful in this effort to ensure that any changes: 1) represent solid and meaningful change that is valuable to financial statement users; 2) focus on the business models used by banking and other financial institutions, and 3) can be implemented and maintained at a reasonable cost.

A major concern is that the current directions in which the FASB and IASB are moving appear to be similarly requiring more MTM within the financial statements, more capital for many existing banking activities, and more operational challenges to comply with these rules for banks of all sizes. The cost of accounting compliance puts continued participation in certain market activities at risk for some smaller institutions.

Another concern is the current divergence between the FASB and IASB proposed models and time frames for completion. The IASB plans to finalize a significant part¹ of its financial instruments accounting standard in 2009, and the FASB’s completion date will be subsequent to that date. In such case, U.S. GAAP will have only one of two choices: (1) to follow the IASB model – which will not provide U.S. companies with appropriate “due process” for providing input, or (2) a lack of international convergence – which should be avoided. Also related to this is that both groups appear to be solving the accounting puzzle on a piecemeal basis, which may result in pre-determining the outcome for subsequent parts of the puzzle that do not fit.

We recognize that the FASB and IASB are under some pressure to finalize their rules quickly; however, we do not believe this should be at the expense of undermining the foundations of financial reporting. It is extremely important that these new standards be developed jointly by the FASB and IASB, with proper due process and open consultation with a wide range of constituents that ensures a holistic review.

¹ The first part will include classification, measurement, and impairment, though methods of impairment accounting are not included in the exposure draft that has been issued. Hedge accounting is also part of the financial instruments project; however it will be considered subsequent to these changes.

Discussion

The financial crisis, which started in 2007, has led a number of groups to provide recommendations that they believe would decrease the risks of a future crisis. The G-20, the Financial Stability Forum, Group of Thirty, and the United States Treasury Department each have provided commentary on the necessity for changes in accounting standards.²

In its 2008 annual report, the FASB agreed that "...the financial crisis has revealed a number of significant deficiencies and points of stress in current accounting standards..." In response to some of the studies and concerns expressed during the crisis regarding accounting for financial instruments, both the IASB and FASB agreed to re-examine certain financial instrument accounting rules. These projects were given high priority, partially due to the reports noted above, and were put on a fast track – significantly faster than any major project previously completed.

In this regard, IASB and FASB have addressed, or are addressing, these critical issues in the manner as shown on the following table.

² Appendix A contains excerpts from reports issued by key organizations and their references to accounting standards.

<u>Issue</u>	<u>FASB</u>	<u>IASB</u>	<u>Expected impact</u>
Financial Instruments: To simplify how loans and securities are measured (MTM, or amortized cost) and whether changes in MTM affect earnings.			
Depending on the financial instrument and circumstance of the purchase, there are currently several different ways to account for a loan or security. The rulemakers' current view is to reduce the number of accounting options to two: MTM and amortized cost. Certain changes in MTM will be recorded in earnings; other MTM changes will be in Other Comprehensive Income ("OCI").	<p>Exposure draft due in first half of 2010. Final statement timing to be determined.</p> <p>All loans and securities to be recorded at MTM on balance sheet.</p> <p>May require more securities to have changes in MTM recorded through earnings.</p>	<p>Exposure draft has been issued. Final decision expected in 2009 and effective in 2012.</p> <p>May reduce assets recorded at MTM on balance sheet.</p> <p>Certain commonly held securities will now have changes in MTM recorded through earnings.</p>	Both proposals may result in a greater use of changes in MTM recorded through earnings. FASB increases the use of MTM to determine "Tangible Common Equity"; IASB may increase the use of MTM for determining income. Increased MTM usage promotes pro-cyclicality.
Rulemakers are considering changing the income statement to include OCI, which includes MTM changes not recorded in earnings.	OCI prominently displayed on income statement, below net income.	Considering including OCI on income statement (as part of joint project with FASB on "financial statement presentation")	Heightened profile of OCI below the income statement will increase emphasis of MTM.
Financial Instruments: Impairment (Reserving for losses)			
<u>Issue</u>	<u>FASB</u>	<u>IASB</u>	<u>Expected impact</u>
Current accounting requires loss reserves only for those events that have already been "incurred". Recommendations have been made to provide for "forward	<p>Exposure draft due in late 2009. Final statement timing to be determined.</p> <p>Implementation expected after 2009.</p>	<p>Request for Information has been issued. Exposure draft expected in October. Final statement expected prior to year-end 2009, for implementation in 2009.</p>	<p>Estimating expected losses is generally in line with recommendations by the study groups. The question is whether cash flow estimates will be</p>

looking” or “expected” losses.	Greater use of expected losses is being discussed and estimating cash flows as of financial statement date.	Greater use of expected losses as the basis for reserves. Preference is for continuous cash flow estimates.	operational. Expected cash flow estimates are much more cumbersome compared to the current incurred loss estimates or expected loss estimates. Current processes for most loans do not estimate specific timing on losses.
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Financial Instruments: Hedge accounting for derivatives

<u>Issue</u>	<u>FASB</u>	<u>IASB</u>	<u>Expected impact</u>
Simplify how hedge accounting may be used in order to better match MTM swings from derivatives used for hedging purposes with the instruments being hedged.	Exposure draft expected in early 2010. Objective is to simplify when hedge accounting can be used and how it is recorded.	Same as FASB. Same as FASB.	Project is expected to result in less onerous rules when hedge accounting is used. However, it may result in fewer situations where hedge accounting may be used.

Rule-makers Appear to be Furthering Mark to Market (MTM)

In recent years, some board and staff members of the IASB and FASB have voiced their preference and goal that all financial instruments be subject to MTM.³ MTM, however, has been the subject of significant criticism over many years⁴ and especially during this financial crisis. One criticism of MTM is its procyclical nature: loan and security market losses caused by credit concerns unnecessarily erode capital,⁵ causing further lending to be restrained, stifling economic growth and increasing unemployment, ultimately resulting in borrower defaults, which triggers the cycle again.

While it has been generally accepted that MTM promotes procyclicality, and both the Group of Thirty and the Financial Stability Forum recommended policies that guard against procyclicality, both the IASB and FASB have indicated directions that will further *promote* the use of MTM (See table above). These include:

³ FASB noted in its accounting standard on hedging activities (SFAS 133): “The Board believes fair values for financial assets and liabilities provide more relevant and understandable information than cost or cost-based measures.”

⁴ ABA’s first white paper on MTM was written June, 1990.

⁵ New accounting rules approved in April 2009 provide that bank regulatory capital is affected only by the expected credit losses in a debt security. Tangible Common Equity, which includes market losses, was not affected by these rule changes.

- The company’s business model appears to no longer be the primary factor in how a financial instrument is measured, resulting in the likelihood that more financial instruments will be subject to MTM.⁶
- Specific commonly-held instruments, such as impaired loans acquired through a merger and non-senior classes of a private label collateralized debt obligation, are targeted for MTM accounting, with fair value changes recorded through earnings.
- In considering how to value impairment of assets that are accounted for at amortized cost, the views of both boards appear to exclusively focus on requiring companies to estimate the amount and specific timing of all cash flows. This is somewhat similar to MTM, depending upon what discount rate is required in calculating the present value of expected cash flows.⁷
- Under both the IASB’s and the FASB’s approaches, MTM would be required for more assets than currently required. The FASB would require fair value for all financial instruments, and the IASB would not go that far; the FASB would require more MTM changes to reported in equity than would the IASB.

In addition to the issues addressed above that appear to require more capital, requiring an expansion of MTM presents onerous operational challenges to banking institutions. For example, in today’s illiquid markets, securities that were acquired as AAA-rated may now be required to have external consultants to perform modeled valuations. These valuations are often performed for fees exceeding \$3,000 per security. Expansion of such requirements put into question whether the costs are worth the benefits. Additionally, it raises the concern about whether community banks can afford to continue to invest in these markets.⁸

Due Process Appears to be Compromised

The FASB and the IASB are moving on similar projects (joint projects), but with different solutions, at different speeds and with different timing for finalizing their rules. With the difference in pace and the degree of change being discussed, there is the concern that due process is insufficient. This concern about lack of due process can be described in two parts:

- Time period for evaluating the proposals – Certain types of changes to accounting rules require more time for financial statement preparers to evaluate the implications of implementation. For example, current accounting rules regarding MTM were issued in 1994 after many years of discussion and due diligence. Those rules focused solely on debt and equity securities rather than today’s discussion, which centers on all financial instruments – effectively a totally new model for financial institution accounting. Field testing of major changes, commonly performed in the past, and open coordination with banking regulators are both critical and time consuming; however, to date, these important due process procedures do not appear to be a part of the standards-setters’ plans.
- International convergence – The differences in timing between the FASB and IASB are likely to result in a lack of due process or a lack of international convergence, neither of which conforms to the

⁶ The Basel Accounting Task Force, in a meeting with the International Banking Federation Accounting Working Group (June 2009), expressed concern about abandoning the business model approach.

⁷ In a fair value calculation, a “market” discount rate is applied to the cash flows. Proposed discount rates by the IASB indicate the effective rate of the instrument at the time of purchase. Such rates are normally different from a market rate, but the calculation is significantly different from the current “incurred loss” approach that does not directly regard timing of the cash flows.

expectations of the study groups above or the investing community. For example, if the IASB finalizes its rule on accounting for loans and debt securities prior to the FASB finalizing its rule, the FASB will likely have only two choices: (a) to adopt the IASB's rules (which does not provide due process in the U.S.), or (b) to adopt a different rule (which would result in divergence between U.S. GAAP and international rules).

While FASB generally adheres to an eight step process (See Appendix C), the IASB's intention to issue its final rule by the end of 2009 puts into question whether a thoughtful deliberation is possible by the boards and by users and preparers whose input is critical. Such quick work is indeed possible and the accounting standards being proposed may sound simple. However, the changes that are anticipated are the most significant ever to be presented and appear to represent radical departures from how accountants have historically viewed the theory behind financial instruments accounting.⁹

While FASB is not required to accept any decisions made by IASB, the Securities and Exchange Commission, FASB, and IASB have been working toward convergence for several years. This convergence effort by the two boards (and the allusion to such convergence in the G-20 report) ensures that IASB actions will be given extra credence during the FASB's deliberations. This is why such action by the IASB is of great concern to U.S. companies.

As noted in our letter to the FASB and IASB (dated August 4, 2009), a costs versus benefits analysis is critical. The sheer volume of change being discussed will be expensive, and the boards must make every effort to ensure that banking institution shareholders will receive benefits relative to the costs of providing new or different information.

Due Process Must Be Coordinated with Regulators

Coordination with regulators on any change relating to these topics is necessary for orderly market transition in understanding the new financial information. This is indicated through the Group of Thirty's recommendation regarding off-balance sheet vehicles "that careful consideration be given to how these rules are likely to impact efforts to restore the viability of securitized credit markets." With that in mind, ABA had requested that the banking agencies provide regulatory guidance at the time of the release of new FASB rules on securitizations and consolidations (FASB Statements of Financial Accounting Standards No. 166 and 167). These new rules, which are expected to significantly increase regulatory capital requirements for entities that securitize assets, puts into question whether such coordination was performed. While some are still digesting the rules and continue to question the logic used in the rules, as of this date, banks have not been notified as to how to react to these new requirements from a regulatory capital perspective. The restoration of securitized credit markets may be delayed further because of these new rules and the lack of information about the regulatory impact.

⁸ The issue of costs for third party verifications is expected to be exacerbated if loans are required to be marked to market.

⁹ Historically, classification and measurement of assets has been determined based first on the business model of the organization (also sometimes referred to as "management intent"). The IASB proposal considers first the complexity of the product and only considers business model afterward in order to determine if the instrument should be accounted for by MTM with changes in MTM recorded through earnings. The default measurement under current FASB proposals is MTM recorded through earnings.

While one could say that this is a regulatory capital issue and not an accounting issue, the FASB issuance also was not coordinated with the IASB, which has a similar project currently underway. Delaying the issuance of these statements until a truly unified, international standard could be developed had been recommended by a number of respondents during the standard setting process. Vast disclosures had been newly required only six months prior to the issuance of these final accounting standards. Thus, transparency of the risk of such securitization structures, the main concern addressed by the newly-issued statements, had been provided.

Why the Rush to Issue these Rules?

Some have noted that demands from the SEC, which may have received pressure from members of Congress, has resulted in FASB's quick issuance of its securitization and consolidation rules – even though it may result in a lack of convergence with international standards and may throw a monkey wrench into recovery.

Similarly, some have indicated that the G-20 recommendation has resulted in pressure on the IASB to finalize its rules on loan and debt security accounting before year-end 2009 – even though it may result in a lack of convergence with U.S. GAAP. However, bankers question whether the massive changes being contemplated by the IASB and FASB were truly contemplated by those requesting quick action. Given the possible consequences upon all financial services industries, bankers believe a more deliberate discussion among these groups, financial statement users, regulators and preparers be conducted to identify what degree of change is needed. For instance, confusion over the mere terms “transparency” and “fair value” can have unintentional adverse repercussions and result in missing a more reasonable repair of current standards.

Additionally, as noted in our letter to the FASB and IASB (dated August 4, 2009), the following points should also be considered when making substantial changes to the accounting model:

- Serious consideration must be given to field testing proposals prior to implementation, and sufficient transition time must be provided.
- Regulatory accounting rules should be consistent with GAAP.
- Accounting changes must meet a “costs vs. benefits” test.

Conclusion

It is time to pause to determine whether the accounting rule-making process is working the way that these major groups have intended. Due process, the emphasis being placed on MTM (when MTM seems to be a source of procyclicality and has proven to be difficult to estimate), and overall coordination and convergence should be reconsidered. The goal should be improving the current accounting rules that are in need of repair within a time frame that provides for due process and permits international convergence in a prudent manner.

Appendix A: Accounting Recommendations from Key Organizations

The G-20¹⁰

Declaration on Strengthening the Financial System, London Summit 2 April 2009

We have agreed that the accounting standard setters should improve standards for the valuation of financial instruments based on their liquidity and investors' holding horizons, while reaffirming the framework of fair value accounting. We also welcome the FSF (Financial Stability Forum) recommendations on procyclicality that address accounting issues. We have agreed that accounting standard setters should take action by the end of 2009 to:

- reduce the complexity of accounting standards for financial instruments;
- strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information;
- improve accounting standards for provisioning, off-balance sheet exposures and valuation uncertainty;
- achieve clarity and consistency in the application of valuation standards internationally, working with supervisors;
- make significant progress towards a single set of high quality global accounting standards; and,
- within the framework of the independent accounting standard setting process, improve involvement of stakeholders, including prudential regulators and emerging markets, through the IASB's constitutional review.

The Group of Thirty (G30)¹¹

Financial Reform: A Framework for Financial Stability, 15 January 2009

“The primary aim of prudential regulation should be to maintain the health of the system and contain systemic risk by... Avoiding accounting, regulatory, or other practices that may inadvertently reinforce recurrent tendencies toward excessive exuberance or risk aversion.... Regulatory policies and accounting standards must also guard against procyclical effects and be consistent with maintaining prudent business practices.”

¹⁰ The G-20 is a group of finance ministers and central bank governors from 20 economies: 19 of the world's largest national economies, plus the European Union (EU).

¹¹ Established in 1978, the G30 is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. The current chairman of the G30 is Paul Volcker, former chairman of the Federal Reserve.

(From recommendations on “Fair Value Accounting”)

- a. “Fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less-liquid instruments and distressed markets.
- b. The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions, apply appropriate rigor to valuation and evaluation of intent, and require improved disclosure and transparency. These standards should also be reviewed by, and coordinated with, prudential regulators to ensure application in a fashion consistent with safe and sound operation of such institutions.
- c. Accounting principles should also be made more flexible in regard to the prudential need or regulated institutions to maintain adequate credit-loss reserves sufficient to cover expected losses across their portfolios over the life of assets in those portfolios. There should be full transparency of the manner in which reserves are determined and allocated.
- d. As emphasized in the third report of the CRMPG (Counterparty Risk Management Policy Group), under any and all standards of accounting and under any and all market conditions, individual financial institutions must ensure that wholly adequate resources, insulated by fail-safe independent decision-making authority, are at the center of the evaluation and price verification process.”

(From recommendations on Restoring Confidence in Securitized Credit Markets)

“Off-Balance-Sheet Vehicles: Pending accounting rule changes for the consolidation of many types of off-balance-sheet vehicles represent a positive and needed improvement. It is important, before they are fully implemented, that careful consideration be given to how these rules are likely to impact efforts to restore the viability of securitized credit markets.”

The Financial Stability Board (formerly “The Financial Stability Forum” or “FSF”) ¹²

London Summit: Leaders’ Statement 2 April 2009

“We agree...to call on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards”

United States Department of the Treasury

Financial Regulatory Reform: A New Foundation -- Rebuilding Financial Supervision and Regulation, 17 June 2009

“The accounting standard setters (the FASB, the IASB, and the SEC) should review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information. Fair value accounting rules also should be reviewed with the goal of identifying changes that could provide users of financial reports with both fair value information and greater transparency regarding the cash flows management expects to receive by holding investments.”

¹² The Financial Stability Board was founded in 1999 to promote international financial stability. Membership includes about a dozen nations who participate through their central banks, financial ministries and departments, and securities regulators, including the United States, Japan, Germany, the United Kingdom, France, Italy, Canada, Australia, the Netherlands and some other industrialized economies. It also includes several international economic organizations. At the G20 summit on 15 November 2008 it was agreed that the membership of the FSF will be expanded to include emerging economies, such as China.

Appendix B: Accounting Standard Setters

United States Accounting Standard-setting: FASB

The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting. Those standards govern the preparation of financial statements. They are officially recognized as authoritative by the SEC and the American Institute of Certified Public Accountants.

There are five Board members of the FASB, of which a simple majority is required to approve new or revised standards.

International Accounting Standard-setting: IASB

The International Accounting Standards Board (IASB) is an independent, privately-funded accounting standard-setter based in London, UK. The IASB is responsible for developing International Financial Reporting Standards (IFRS) and promoting the use and application of these standards. As part of this, the IASB negotiates with standard-setters in each country so that each country will adopt IFRS. Virtually all European countries have adopted IFRS. Countries such as the United States, Japan, China, and India have agreed to "converge" accounting standards with IFRS in the future, though, at present, none of these countries permits IFRS to be used.

There are thirteen members of the IASB (of which four are from the U.S.) and nine are required to approve any new or revised standards.

Convergence

In 2002, FASB and the IASB agreed upon efforts to converge accounting standards, thus creating one standard that each company would uphold, no matter the country of residence. While the SEC has set timetable targets over the next three years, comments from FASB member indicate that total convergence is unlikely for several years. However, decisions made by one body certainly influence those of the other body.

Appendix C: FASB Due Process – Steps Required by the Rules of Procedure

The FASB has established the following procedures for developing accounting standards. These procedures are used for major agenda projects. Not all of the steps may be necessary for application and implementation projects. Many other steps are followed during the course of the project that are not specifically required by the Board's Rules of Procedures.

1. The Board receives requests/recommendations for possible projects and reconsideration of existing standards from various sources.
2. The staff summarizes the information it receives and discusses its findings at a public Board meeting as part of the agenda-decision-making process.
3. The Board votes on whether to add the project to its agenda. A simple majority vote is needed.
4. The Board deliberates the various issues identified and analyzed by the staff at a series of public Board meetings.
5. The Board issues the Exposure Draft. (In some projects, the staff may prepare and issue an Invitation to Comment or Preliminary Views prior to the Board issuing an Exposure Draft.)
6. The Board holds a public roundtable meeting on the Exposure Draft, if necessary.
7. The staff analyzes comment letters, public roundtable discussion, and any other information and the Board re-deliberates the proposed provisions at public meetings.
8. The Board issues a Statement or Interpretation by simple majority vote.