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Via email: director@fasb.org

File Reference: No. 1810-100 *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

Re: Classification and Measurement of Financial Assets and Liabilities
(ABA Comment Letter 1 of 3 for File Reference 1810-100)

Dear Mr. Golden:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Exposure Draft: *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (ED). ABA represents banks of all sizes and charters and is the voice for our nation's $13 trillion banking industry and its two million employees. The majority of ABA's members are banks with less than $165 million in assets. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities.

The ED represents major changes to bank financial reporting. Because of the importance of the issues addressed in the ED, as well as the wide range of issues within, ABA is dividing our response to the ED in three parts: 1) classification and measurement of financial assets and liabilities, 2) credit impairment of financial assets, and 3) derivative instruments and hedging activities. This is the first of our three comment letters and will focus on the classification and measurement of financial assets and liabilities, as well as other general topics.

The ABA strongly believes that the mixed measurement approach is the most relevant and reliable model, and we disagree with the proposal to expand "fair value accounting" [1] to all financial instruments. [2][3] This view is shared globally by the banking industry[4] and many others. Much attention

[1] "Fair value" is the technical term used in the ED and in other accounting standards, though we believe "mark to market" is more descriptive and we have used "market value" and "mark to market" in place of "fair value" in other comment letters.

[2] ABA has written numerous letters, during the period of 1990 through today, to the FASB, the IASB, SEC, and others. A few examples are:

- ABA's letter (May 31, 2000, File Reference 204-B) in response to the Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*, dated December 14, 1999.

has been given to fair value accounting over the past three years by world-wide accounting standards setters, regulators, former regulators, bankers, and financiers of all types. Bankers have warned against the various unintended consequences for years, but their qualitative arguments about the lack of reliability combined with the devastating procyclical effects of fair value accounting became virtually self-evident during the financial crisis of 2007-2008. Organizations such as the Financial Stability Board, while advocating more forward-looking impairment provisions, have expressed serious concerns regarding fair value accounting.[5] Accounting standards that are procyclical have also had a prominent place on the agendas of the G20.[6] Further, the significant and substantive world-wide investor outreach – which included the U.S. – performed by the International Accounting Standards Board (IASB) [7] convinced them that users of bank financial statements do not generally want fair value accounting for

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- ABA's letter (November 13, 2008, file number 4-573) to SEC during its study of fair value accounting. ABA has also participated in international papers, written by the International Banking Federation Accounting Working Group (for example, see *Accounting for Financial Instruments Conceptual Paper*, April 2008) and its predecessor, the Joint Working Group of Banking Associations (for example, see *Accounting for Financial Instruments for Banks*, October 1999).

[3] ABA agrees with the use of fair value accounting for assets that are traded; however, the traditional banking model is to hold loans and many debt instruments for their contractual cash flows. Therefore, the increase in the use of fair value accounting that is being proposed in the ED would provide less relevant and less transparent information.

[4] See International Banking Federation papers.

[5] The Financial Stability Board, *Improving Financial Regulation - Report of the Financial Stability Board to G20 Leaders,* September 25, 2009: "We strongly encourage the IASB and FASB to agree on improved converged standards that will…simplify and improve the accounting principles for financial instruments and their valuation. We are particularly supportive of continued work in a manner that does not expand the use of fair value in relation to the lending activities (involving loans and investments in debt instruments) of financial intermediaries.

[6] For example, see G20 Working Group 1: "Enhancing Sound Regulation and Strengthening Transparency Final Report", March 25, 2009. Also, see G20 "Declaration on Strengthening the Financial System", London, 2 April 2009:

- "[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."

[7] The IASB discussed classification and measurement globally with investors and found that investors do not prefer fair value. Additionally, the IASB's international advisors, the Standards Advisory Council, discussed fair value accounting at several of its meetings. (The purpose of the SAC is to advise the IASB on a range of issues – including the IASB's agenda – and its membership consists of a wide range of representatives from users of financial statements, preparers, financial analysts, academics, auditors, regulators, professional accounting bodies and investor groups.) At its February 24, 2009 meeting, the SAC was asked to vote among three accounting models to account for financial instruments that the FASB and IASB were beginning to consider at that time. The proposals and votes were as follows:

1. Fair value for all financial instruments – 2 votes
2. Mixed model, using amortized cost if there are contractual payments for the financial instruments, otherwise fair value – 8 votes
3. Mixed accounting model, with all trading instruments at fair value and the remaining at amortized cost, with one impairment rule – 26 votes

The vote count demonstrates a significant lack of support among SAC members for fair value accounting for all financial instruments.

financial instruments. Indeed, the logical result of fair value accounting, with companies recording significant gains as the credit rating of their debt drops, has been broadly derided.

With all this experience, it is difficult to understand why the centerpiece of the ED is to expand fair value accounting to all financial assets and liabilities. This appears to fly directly in the face of the desires of virtually all constituents of financial statements: knowledgeable users of bank financial statements – including investors – who do not want it, banking managers who do not use it to manage their businesses, and regulators[8] who believe it is dangerous.

We also continue to be concerned about the impact of changing the accounting model for the banking industry versus other industries as well as the costs versus benefits. In previous communication[9] with the FASB, the ABA has requested that the FASB focus on the following:

- What is the logic of accounting for financial instruments at market value, but not using fair value as the model for all assets and liabilities for all industries?[10]
- 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 fair value accounting? [11]

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[8] For example:

- FDIC Chairman Sheila Bair, interviewed by Steve Forbes on www.forbes.com (August 2, 2010):
  - For "deposits and loans held to maturity, there's no liquid market for them." She further stated: "There is no way to mark them really that would be realistic and I think helpful to investors. So requiring these loans to be mark-to-market as opposed to held at amortized cost I think will be less transparent, not more transparent. This Level III modeling that is contemplated under FASB rules for mark-to-market assets where you don't have a market to look to for pricing did not work well during the crisis. My preference would be for FASB to stop. Don't expand fair value accounting."
  - "I think all the bank regulators are very much concerned and do not support this proposal."
- Former Federal Reserve Chairman Paul Volcker, interviewed on CNBC with Larry Kudlow, June 14, 2010 on mark to market:
  - "…it's appropriate for trading operation, it's appropriate for instance if you are going to trade. It's not appropriate for the basic portfolio of instruments that you have created with a customer and intend to hold--the loan portfolio."
  - "…I hope they will get enough comments to say that this is both not suitable on its own merits and certainly not suitable to lead to an unnecessary clash with the international [accounting standards], where I think the weight of the evidence is certainly on the international side. And we end up with, hopefully an international accounting system that makes sense."

[9] See ABA letter to FASB and IASB (August 4, 2009).

[10] The ABA is not proposing that fair value accounting be used for the entire balance sheet. However, the use of fair value accounting solely for financial instruments, particularly those that are not traded or intended to be sold, should be evaluated against the use of fair value more broadly. This includes determining whether the accounting standards would be placing one industry at a disadvantage versus other industries by making a "practical cut" with financial instruments at fair value. The ED does not provide sufficient information for us to evaluate how or why the decision was made to limit fair value to financial instruments.

[11]One of the guiding principles that is part of the mission statement of the FASB is: "*To issue standards only when the expected benefits exceed the perceived costs.* While reliable quantitative cost-benefit calculations are seldom possible, the FASB strives to determine that a proposed standard will fill a significant need and that the perceived costs it imposes, compared with possible alternatives, are justified in relation to the overall expected benefits." [emphasis added]

- What will the impact be on products provided by financial institutions?
- Given that 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 are critical issues that must be considered when examining the costs versus the benefits of the ED. We appreciate the FASB's efforts to better understand the costs versus benefits in its field visits with banks, and we urge you to examine the above issues during the deliberation process.

Accounting for Financial Instruments Should be Based on the Business Model

ABA supports accounting that is based on the business model: instruments managed for fair value and trading purposes should be accounted for at fair value, while those managed for long-term investment in order to collect the contractual cash flows should be accounted for at amortized cost, with a vigorous impairment model. Such an accounting model reflects how the entity will generate its future cash flows. Most importantly, it reflects how the company manages its business, which is key information for investors.

With this in mind, ABA strongly urges the FASB to reject the proposal to record all financial assets (including loans) and liabilities at fair value on the balance sheet. Both the G20 and the Basel Committee on Banking Supervision have recognized this, recommending to the IASB that its accounting for financial instruments be based on the business model. It is our understanding that some at the FASB believe the ED is based on the business model because certain changes in market values are reported in earnings while others are reported in other comprehensive income. We disagree with this notion, and we believe this is not what the G20 and the Basel Committee are recommending. The G20 Banking Statement (September 5, 2009, London), recommends the following:

> "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…"

The Basel Committee on Banking Supervision's, *Guiding principles for the replacement of IAS 39*, contains the following:

> "There should be a strong overlay reflecting the entity's underlying business model as adopted by the Board of Directors and senior management, consistent with the entity's documented risk management strategy and its practices, while considering the characteristics of the instruments."
>
> "Fair value should not be required for items which are managed on an amortised cost basis in accordance with the firm's business model…"

Contrary to what is stated in the ED, across-the-board fair value accounting for all financial instruments does not reflect a bank's business model. In fact, in light of the emphasis by both banking regulators and investors on different aspects of bank capital, the proposal will significantly distort bank performance and financial position.

ABA supports transparency of financial information. However, ABA notes that the fair values of loans held for long-term investment are already disclosed in the footnotes. Because it is not relevant to traditional commercial bank operations (in other words, it is not relevant to how the bank will generate its cash flows), this information is appropriate only for footnote disclosure. Combined with the separate, but related proposal to provide one statement of comprehensive income, FASB is changing the performance measure for banks to that unrelated to the management of credit. As a result, FASB is attempting to change how commercial banks are managed and how they are evaluated by analysts, and implementation of this aspect of the ED will have significant deleterious effects. Our opposition to full fair value accounting for core banking activities, which has been consistent and unwavering for over twenty years, is based on the following:

- Fair value accounting is not relevant to the commercial banking business model.
- Fair value accounting will undermine the reliability in bank capital levels and decrease comparability between banks.
- Fair value accounting introduces complexity where complexity is neither needed nor desired.
- Fair value accounting will require significant costs to banks with little benefit to users.
- Fair value accounting changes the concept of "comprehensive income" within FASB's Conceptual Framework.
- Fair value accounting complicates efforts to converge GAAP with IFRS and creates a competitive disadvantage to U.S. banks.
- Fair value accounting will add unnecessary procyclicality to the financial system.

Fair value accounting is not relevant to the commercial banking business model.

Considering loans are normally held by commercial banks for the long-term, bank financial statements will be clouded with data that is irrelevant in determining the key metrics of the commercial banking model: bank capital and "bottom-line" return. Recording fair values of loans masks the most important aspect of the banking business model: managing the credit risk of customers. Performance will be distorted with unrelated market reactions to interest rate, credit spread, and liquidity movements.

To show why those market reactions are irrelevant to a typical commercial bank's operations, one need go no further than their local banker. If a borrower demonstrates financial difficulty, the typical banker does not sell the loan, the banker works out the loan with the customer. This work out process may involve modified payment terms, additional collateral provided by the customer, or even significant changes to the customer's operations in order to meet the payment schedule. The value of the loan is rarely realized through an immediate sale.

With this in mind, bankers are not "hiding behind" the business model argument for their own sake. Bankers are reliant on their investors for funding and are appropriately responding to their needs. For example, in a recent survey, consisting of hour-long interviews, PricewaterhouseCoopers[12] found that 72% of investment professionals who analyze banks believe the business model is a primary consideration in determining an instrument's measurement basis. In the survey, only 17% believe that the fair value of loans should be recorded on the balance sheet – 21% feel the same regarding core deposits. ABA has found overwhelming opposition to fair value for all financial instruments in its informal discussions with bank investors and with both sell-side and buy-side analysts, and in a recent newsletter from Stifel Nicolaus, it was reported that during the banking regulators' July 29 roundtable-conference call, which was held in order to receive investor input on the ED, none of the 100 or more investors spoke up in favor of the ED; instead, all those who spoke were opposed. These professionals – those who actually follow banking institutions on a daily basis – want to be able to continue to understand how banks are managed from the bottom up.

We encourage the FASB to focus on banking institution investors and depositors – from the most sophisticated to the least sophisticated. Because the FASB has made a practical cut at fair value accounting for financial instruments as opposed to all assets and liabilities, and because financial instruments are the primary products and services of banking institutions, the ED effectively changes the entire accounting model for banks. If the ED becomes final, then we believe it is inevitable that banks will react to the new accounting model by changing their product mix and approach to banking. In other words, this ED is proposing to change how commercial banks are run.

Fair value accounting will undermine the reliability in bank capital levels and decrease comparability between banks.

Capital is a critical measure for various stakeholders in a bank. Whether referring to Tier 1 regulatory capital, tangible common equity, or total capital, regulators and depositors who are interested in safety as well as investors who analyze return on equity and forecast future capital needs focus closely on these balances. With this in mind, the reliability of reported bank capital will decline by marking to market financial instruments. Basically, information in bank financial statements will not satisfy the adequate thresholds of reliability and comparability, as there is no active market (and, in many cases, never has been) for the vast majority of commercial loans held by most banks. In essence, such values must be derived by "making up" an imaginary market in which to sell these loans. This obviously invites enormous variability in assumptions and in any recorded amounts. For example, during a recent process to acquire a portfolio of impaired loans, one bank hired two different independent consulting firms to value the portfolio. The range of the two estimates exceeded $500 million – over half the $1 billion par value of the total portfolio. Therefore, we believe that determining fair values for assets and liabilities will often be, for all intents and purposes, an exercise in imagination for many entities. While such speculation may be acceptable for disclosure purposes, it is clearly inappropriate in determining capital or measuring financial performance. In fact, as small modifications to certain fair value assumptions can have large impact to the recorded value of loans, a company's financial performance may become highly subjective.

[12] See PricewaterhouseCoopers, *What investment professionals say about financial instrument reporting*, June 2010.

These values also will not reflect a loan's true value to the enterprise, since it must exclude the value of other products and services that are critical to the total customer relationship. Because of this, as well as the greater knowledge the bank has about the borrower's credit,[13] the value of a loan is greater to the bank than it is to an outside party. Additionally, due to the fact that most commercial loan markets are typically inactive, estimating their "fair value" often necessitates a significant liquidity discount. Under the ED, this would often result in a loss to be recorded at inception in comprehensive income. Further, due to the unique terms involved in most commercial loans, distinctive underwriting standards in individual banks, as well as differing perceptions of the liquidity discounts required for the wide range of products and lending sectors, comparability between banking organizations will be tarnished. In fact, the lack of comparability is one of the common themes ABA hears from banking analysts as to why fair values are not currently relied upon in their analyses.

Further undercutting reliability in capital levels is an inevitable result of full fair value accounting for financial liabilities: troubled banks may report improvements in capital when their credit ratings decline. This incredulous outcome may occur when the fair value of their debt declines. Although this may be the appropriate accounting in a fair value model, it is also beyond belief that financial statement users will find this result – or fair value for assets – useful. While the Board has proposed separately highlighting such an amount within the body of the financial statements, the bottom line will remain clouded with this result.

Fair value accounting introduces complexity where complexity is neither needed nor desired.

The majority of loans held by most commercial banking institutions have no active secondary market. As a result, the vast majority of the balance sheet will require modeling to estimate fair values with "level 3" inputs[14] – as opposed to using quoted prices. Investors would then be required to digest the numerous assumptions, which would vary from entity to entity. They will need to understand how banking models determine interest rate, credit, and liquidity discounts across wide ranges of products and geographic areas. With this in mind, in order to evaluate corporate performance, investors and other stakeholders will be required to decipher why differences exist between the amortized cost (after reserves) and fair values and, effectively, will not be able to compare entities. Over long periods of time, these differences may possibly provide a picture of relative interest rate and credit risk assumed between entities. However, such snapshots are not indicative of how effectively a bank executes its business model.

Compounding this complexity, requiring fair value accounting on loans necessitates a reciprocal fair value measurement of deposits, including a core deposit intangible asset (CDI). The ED, however, does not use a fair value measurement; instead, it proposes a present value method to estimate the CDI that will exclude certain major factors (for example, customer relationships) normally used in estimating the

[13] Banks typically have more information about a borrower's credit than does the market, resulting in asymmetrical information. FASB Statement No. 157 assumes that a market participant would perform due diligence that is "usual and customary". This risk presented by asymmetrical information results in further discounts that do not reflect the loan's actual credit risk.

[14] Under SFAS 157, level 3 inputs are generally considered to be the least reliable estimates of fair value.

fair value of the CDI. Since this calculation will conflict with the current methods to recognize and measure CDIs within a business combination, financial statement users will be required to either differentiate between the two, or completely relearn what the CDI represents in the financial statements.

Although the concept of the CDI initially appears acceptable when also valuing assets at fair value, it introduces complexity related to alternative funding and maturity assumptions that investors have not desired. With the infrequent exception for business combinations, investors almost never ask about the inherent value of deposits – fair value or present value – and it is likely that customers would be aghast to learn that their accounts will be recorded on a bank's books and records for amounts less than the deposit's principal balance. Training depositors to understand the notion that the "market value" of their deposits is less than what is owed is a tall order.

Fair value accounting will require significant costs to banks with little benefit to users.

Combined with the current fair value measurement exposure draft, which proposes to require sensitivity disclosures for those financial statement items using level 3 fair value inputs, banking costs will significantly increase, with little incremental benefit for those long-term equity and debt investors in banking institutions. In other words, the vast majority of long-term investors in banks has not historically been, and is not currently, asking for this information and is unlikely to use it significantly in their financial analysis. In a survey of banking chief financial officers we performed, a tiny minority of both publicly-held and privately-held banking institutions report having moderate or significant discussions about the fair values of their loan portfolios from 2007 to 2010. This is during a time period during which one might expect such discussions, as the financial crisis grew. Our own outreach to dozens of both sell-side and buy-side banking analysts indicated no need for expansion of fair value accounting. In fact, virtually all analysts we talked to who specialize in the banking industry did not rely on fair values and oppose this measure.

These results should not be surprising. Fair values are not a significant part of commercial bank financial analysis. Indeed, education courses related to commercial bank analysis and offered by the New York Society of Security Analysts (NYSSA)[15], while in-depth regarding many individual issues relating to bank analyses, are silent on the fair value of loans – fair values are not considered when analyzing bank financial statements. With this in mind, for the extra anticipated preparation time, personnel, and audit work, virtually every company will experience higher costs due to this new requirement. For those banks that present a balance sheet completed in accordance with GAAP during their earnings announcements, this will also impact the timing of those announcements – likely delaying them. Clearly, the proposal will require higher costs for no additional benefit. In fact, the costs incurred are expected to result in inferior rather than improved quality of financial information for investors.

[15] With over 11,000 members, NYSSA is the largest of the societies comprising the CFA Institute. In 2010, NYSSA has offered a wide range of education courses, including "Analyzing and Interpreting Bank Financial Statements Primer" and "Bank Financial Modeling."

Fair value accounting changes the concept of "comprehensive income" within FASB's Conceptual Framework.

Within the Accounting Standards Codification, "comprehensive income" and "other comprehensive income" have historically been understood in relation to an entity's ability to generate favorable cash flows. That is why the fair values of loans held for investment and held-to-maturity securities (not subject to other than temporary impairment) are excluded from comprehensive income. Such fair values are not relevant to the generation of future cash flows. To now include changes in these fair values within a statement of comprehensive income is to change one of the main objectives of financial reporting: relevance. Relevance is further corrupted by the related FASB exposure draft that would require one statement of comprehensive income that presents net income as a subtotal and practically redefines "the bottom line", which will reflect all fair value changes. Bankers believe that the objective of the performance statement is to reflect how effectively management executes its business model. The current proposals complicate that objective. While we acknowledge that fair values may provide information useful to some, we disagree that such information is relevant to an institution's performance when the institution manages such assets and liabilities for the collection of specific cash flows unrelated to their market values.

Such a change to the concept of relevance requires extensive and comprehensive deliberation on the Conceptual Framework, not only as it affects banks, but entities in all industries. With this in mind, we urge FASB to reject any change to the options provided for presentation of the current performance statement and, prior to issuance, complete its review of the Conceptual Framework.

Fair value accounting complicates efforts to converge GAAP with IFRS and creates a competitive disadvantage to U.S. banks.

The proposal to expand fair value accounting is in direct conflict with the recently issued IFRS 9 *Financial Instruments*, issued by the IASB in November 2009. Instead of progressing to one set of high quality accounting standards, the ED proposes to dramatically increase the differences between the two sets of standards. While we understand that the original goal of convergence by 2011 may be justifiably postponed, the ideological difference between FASB requiring fair value accounting for all financial instruments and the IASB basing the accounting upon an entity's business model is likely to slow the convergence process to a halt. In fact, some believe that if the FASB were to proceed with the ED, then the banking industry should encourage the SEC to accept IFRS for U.S. registrants within an earlier time frame than is currently being considered, since future adoption of IFRS may be inevitable and IFRS would more clearly reflect the business model of banking.

Further, if U.S. companies are required to expand fair value accounting, the costs of implementation and administration, along with the increase in financial statement volatility, will put U.S. companies at a competitive disadvantage with their IFRS-based competitors in pursuing capital world-wide. There is no question that both higher costs and additional volatility will increase the cost of capital for U.S. companies.

Fair value accounting will add unnecessary procyclicality to the financial system.

By implementing fair value accounting, systemic risk is added to the financial system by unnecessarily adding to volatility of bank capital, and, thus, procyclicality. Whether linked to regulatory accounting or not, procyclicality both adds to the cost of capital of banks and exacerbates financial cycles. When a bank's performance is based on factors that are unrelated to credit risk – such as for the significant liquidity discounts that have been prevalent since the beginning of the financial crisis or the routine movements in interest rates – its performance becomes a result of factors unrelated to its business and irrelevant to the investor who is seeking long-term capital growth. Further, while marking deposit liabilities to market may mitigate a portion of the volatility caused by interest rate movement, this practice can actually exacerbate the problem in times of economic contraction.

Those who believe that fair values of financial assets and liabilities are effective predictors of credit losses need look no further than the power of procyclicality as it ravaged its way through the economy in 2007 and 2008. Subjecting bank financials to the wild volatility experienced in the last few years also ignores that banks are unique in their responsibility to serve illiquid markets while having deposits available for immediate withdrawal. Those who advocate the market's long-term efficiency, thus, must understand that short-term inefficiencies can irreparably harm specific institutions.

With that in mind, while we recognize that sophisticated investors may understand the differences between fair value-based results and non-fair value results, other stakeholders should not be expected to effectively assess the fine details. Performance statements based on temporary fair values can subject banks to significant risk when the results are not thoroughly understood. ABA agrees with world banking regulators[16], as well as leading figures, such as FDIC Chairman Sheila Bair, former Federal Reserve Chairman Paul Volcker, and former FDIC Chairman William Isaac – all of whom believe fair value accounting should not be expanded. In addressing the problems that led to the recent financial crisis, while there was discussion by expert groups regarding improving loss reserving techniques and recognition of certain off-balance sheet vehicles, there was no mention of expanding fair value accounting. In fact, it was widely accepted that fair value accounting played a role in exacerbating the crisis.

We appreciate FASB's concern for the ED's potential impact on smaller institutions (as evidenced by the proposed four year deferral of the requirements for loan fair values and core deposit intangibles) and support the deferral, but we also believe the impact of such a deferral sounds more appealing than it is. Our primary concern is that the FASB has made it clear that "exit prices" will be required in the SFAS 107 footnote disclosures during the deferral period, rather than the practical estimates of fair value provided for in SFAS 107[17] that are currently being used by many small banks. If the smaller institutions are required to provide exit prices at the effective date of the ED, then the community banks must develop systems and processes for estimating exit prices in an environment where efficient information systems do not yet exist. Presumably, after the large banks implement the ED, such systems will have been developed and the smaller banks would be able to use the improved systems and

[16] Basel Committee on Banking Supervision, "Guiding Principles to Replace IAS 39", August 2009.
[17] See paragraphs 14 and 15 of SFAS 107.

processes. If the smaller banks are required to provide exit prices during the deferral period, they must, effectively, go through two different implementation processes. We agree with the delay for smaller institutions and believe that the deferral period will need to be extended based upon our recommendation that the implementation by larger companies be four years from the release date. That said, even though the costs of compliance are relatively much higher for smaller institutions, expansion of fair value accounting is not appropriate for any traditional bank, whether small and privately-held or large and publicly-held, for the same reasons of relevance, reliability, and cost-benefit. Further, implementation of such a standard could have devastating effects on the overall economy.

Other Significant Matters Relating to the ED

In addition to addressing the implementation of fair value accounting for all financial assets and liabilities, ABA has the following comments on other significant areas within the recognition and measurement portion of the ED:

- Fair value accounting of a company's own debt distorts performance: gains are realized when company performance declines.
- Reclassification of assets and liabilities should be permitted to reflect changes in strategy.
- Cost method accounting should be continued for certain equity investments.
- Current rules for equity method of accounting for equity securities should be maintained.
- Commitments related to credit card arrangements should be excluded from the scope of the ED.
- There should be consistency in initial measurement.
- Implementation will be lengthy and costly.
- Other transition issues need to be addressed.

Fair value accounting of a company's own debt distorts performance: gains are realized when company performance declines.

ABA agrees with the many investors who believe that recognizing gains due to declines in an entity's own credit rating not only blurs transparency, but directly masks it. Both good and poor financial performance will be distorted – even contradicted – by these marks. The recognition of gains in such a situation also appears to contradict the "going concern" principle – entities should not recognize improved financial performance because of a grave financial condition. However, this is a necessary evil of fair value accounting.

Thus, ABA supports efforts to separately identify any fair value change related to changes in an entity's own credit rating. While we disagree with recognizing such unrealized gains through net income or other comprehensive income (OCI) in any situation, we believe recognizing these gains in other comprehensive income is preferable to net income recognition. ABA also cautions that the impact of recognizing these gains through OCI is negated by the proposal to require one continuous statement of comprehensive income, which implies that total comprehensive income is the new "bottom line." Such gains, if the proposals are adopted, will still be reflected in a bottom line number that will likely be the focus of many users of financial statements.

Reclassification of assets and liabilities should be permitted to reflect changes in strategy.

ABA believes that reclassifications of financial assets and liabilities between those held for trading purposes and for long-term purposes should be allowed under specific circumstances. This view was also expressed by the Basel Committee on Banking Supervision to the IASB, as follows:

> "The new standard should…permit reclassifications from the fair value to the amortised cost category; this should be allowed in rare circumstances following the occurrence of events having clearly led to a change in the business model…"[18]

The first circumstance for permitting reclassifications should be, consistent with the "business strategy" basis of classification used in the ED, when the business strategy or business model changes. Thoughtful and deliberate changes, for example, during a business combination, realignment of operations, or for significant changes in corporate liquidity, would be reflective of the natural course of business.

Another common circumstance is when assets are originated or acquired with the understanding that they will be sold under a pre-existing agreement (for example, forward purchase and sale agreements with government-sponsored enterprises) and that forward agreement is terminated. Such terminations may occur because of insufficient volume to be sold under the agreement or through a pay-off process. In these situations, the business strategy regarding these assets may logically change.

Cost method accounting should be continued for certain equity investments.

ABA opposes the requirement for fair value accounting for all equity investments not subject to consolidation or the equity method of accounting. For practical reasons, reliable fair values of many privately-held entities are virtually impossible to determine, due to the lack of timely financial statements produced by many small companies. Such a requirement will further introduce concerns about reliability and unnecessarily introduces a complexity to the financial statements where such complexity is neither desired nor necessary.

Current rules for equity method of accounting for equity securities should be maintained.

ABA opposes the requirement that an investee's operations be related to the entity's consolidated business in order to qualify for the equity method of accounting for equity investments. Questions on the relation of one business to another will inevitably arise without more guidance. For example, holdings in tax-related investments, such as low-income housing entities, may be considered related to certain banks, but not others. In many cases, the non-administrator/investor is not solely interested in the housing aspect of the entity, but also of the cash flows related to income tax credits. Because the

[18] See Basel Committee on Banking Supervision, *Guiding principles for the replacement of IAS 39*. The G20 recommended that the IASB take into account those principles when developing its new accounting standard for financial instruments.

value of these credits depends solely on the tax benefits to a specific organization, and not on the value of the organization's shares, fair values of equity shares are not helpful to the financial statement user.

Commitments related to credit card arrangements should be excluded from the scope of the ED.

ABA believes that unfunded loan commitments related to credit card arrangements should be excluded, as proposed, from the requirement to be recorded on the balance sheet at fair value. Like many other loan facilities, the value of such a commitment is often undistinguishable from the value of the account itself, which includes significant value from transaction-based fees, marketing opportunities, and other promotional value. In addition to this, commitments on credit card arrangements often are unilaterally cancelable by the issuer at any time.

With this in mind, for the purposes of investor information, ABA believes that determining a fair value for standby letters of credit (SLOC) or for unfunded loan commitments is, in general, fraught with the same pitfalls as the fair value of the loan itself. For most SLOCs or unfunded commitments on loans that are not held-for-sale (for example, for revolving corporate credit lines), there is normally no active market. Bid and ask spreads are significant in instances when they are traded, so the reliability of such estimates is often significantly reduced. Further, the relevance of such information is negligible, since any fair value changes will not be recognized as cash flows to the bank. With such questionable reliability and relevance, bank capital, one of the most critical elements in analyzing bank performance and risk, should not be subject to changes in the fair value of any unfunded loan commitments.

There should be consistency in initial measurement.

The ED proposes initially measuring trading assets at fair value (with transaction costs immediately expensed) and initially measuring assets held for long-term investment at transaction price, unless there is a significant difference between the transaction price and fair value. Although the immediate expensing of transaction costs for trading assets is consistent with the current accounting used with the fair value option, we understand that the Board's proposal to separate such transaction costs relates primarily to the investment company industry, since important expense metrics may be based on such numbers. ABA believes that such a desire should be reflected in industry-specific guidance, since investors in investment companies have very different needs from those in financial institutions. The accounting should not be determined on a general financial instrument basis, but should be based on the business model.

From a practical perspective, the notion of comparing transaction price with fair value in a loan issuance can be a day-by-day exercise that is fraught with complexities. We also note that transaction costs for a fixed income security trade are normally embedded in the bid/ask spread, but separately valued in the commission charge in an equity security transaction. Therefore, separating out transaction costs and determining the actual fair values in these circumstances are often cumbersome processes. Additionally, for two of the important metrics in banking – net interest margin, and investment gains and losses – related direct costs should be recorded in a consistent manner. With all this in mind, ABA believes that there must be more guidance to efficiently establish daily fair values within the transaction process.

First and foremost, however, there should be consistency in measurement, whether for a trading asset or long-term investment.

Implementation will be lengthy and costly.

Implementation of the rules as proposed will be complicated and likely take a minimum of four years after the final standard is released for those banks that do not qualify for the four-year deferral. The individual phases of fair value accounting and of impairment (including the change to the recognition of interest income) will take significant time. The four year period is a high-level estimate that is influenced by a number of factors and the timing of their resolution:

- Prior to incurring costs for information systems changes, banks will need to know whether there will be any regulatory changes related to the final standard that could also result in systems changes. Regulators must determine how these accounting changes will factor into capital requirements and periodic reporting.
- Software vendors must evaluate requirements and develop software frameworks. Since the processes proposed in the ED are processes never before performed[19], it is likely to take several years before a generally accepted software solution framework will emerge.
- Data that has never been tracked for accounting purposes must be gathered. This includes factors related to fair values, certain customer deposit trends, as well as life-of-loan losses.
- Education of loan officers as managers of fair value processes must be performed.
- Projects must be undertaken to change loan processing systems in order to account for fair values and impairment on a loan or pool level.
- Efforts are required to determine and analyze specific markets on industry, geographic, and programmatic levels on a timely basis. These include the determination of appropriate credit, interest rate, and liquidity adjustments. Efforts must also address procedures to determine when overall market liquidity has significantly changed and how those changes impact specific valuation models.
- Integration of fair value modeling into general ledger systems within mandated closing periods will be necessary.
- Reengineering of closing processes related to interest income recognition will be required to comply with regulatory deadlines.
- Education is necessary of users as to understanding fair value results. Despite the proposed cumulative effect adjustment, this will likely require a minimum of three years of prior period data for comparative results.
- Internal controls must be developed and tested for internal purposes and to comply with Sarbanes-Oxley requirements.

[19] SFAS 107 requires fair value footnote disclosures for financial assets and liabilities. However, the requirements of the ED differ from SFAS 107 (for example, paragraphs 14 and 15 of SFAS 107), which will result in significant process changes for many, if not most, banks. Additionally, the processes required for recording unfunded loan commitments at fair value, for interest income, and the customer deposit intangible in the ED are not currently available on banks' systems.

Other transition issues need to be addressed.

ABA believes more transition guidance is required regarding a number of different areas:

- Guidance must address any restatement of the core deposit intangible that may be needed due to the different valuations used on an ongoing basis under this ED versus the valuations currently used for business combinations and similar acquisitions.
- Additional disclosures will be needed in the likely circumstance of a business combination where fair values of assets and liabilities are significantly different than those recorded prior to the transaction.
- Since financial assets are being added to the balance sheet and measured on a different basis (for example, many loan commitments are being added and a significant percentage of assets will be at fair value), the $1 billion total assets amount (to qualify for deferral) will be variable. More guidance is required to determine whether a bank will qualify for the deferral. Further, future changes in accounting standards that will result in changes to the level of recorded assets (for example, in lease accounting) will also need to be explained as to their impact on the deferral scope.
- Smaller, non-public entities and their auditors will need additional education and guidance in order to adequately comply with the proposed standards.

On the attached pages, ABA provides responses to some of the various questions posed in the ED that relate to the classification and measurement of financial assets and liabilities. This letter also confirms our earlier discussions with your staff that ABA has registered to participate in the roundtable meetings scheduled for October 2010.

Thank you for your attention to these matters and for considering our views. Again, ABA will also be submitting separate comment letters on credit impairment of financial assets and on derivative instruments and hedging activities. Please feel free to contact Mike Gullette (mgullette@aba.com; 202-663-4986) or me (dfisher@aba.com; 202-663-5318) if you would like to discuss our views.

Sincerely,

Donna J. Fisher

Donna J. Fisher

Questions Raised in Exposure Draft on Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities[20]

Scope: For All Respondents

Question 1: Do you agree with the scope of financial instruments included in this proposed update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?

> **Response:** ABA does not agree with the scope. Financial instruments that are traded should be marked to market; other financial instruments should not be included in the scope. The reasons for this are covered in depth in the cover letter.

Question 2: The proposed guidance would require loan commitments, other than loan commitments related to a revolving line of credit issued under a credit card arrangement, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

> **Response**: ABA believes that unfunded loan commitments related to credit card arrangements should be excluded from the requirement to be recorded on the balance sheet at fair value. Like many other loan facilities, the value of such a commitment is often undistinguishable from the value of the account itself, which includes significant value from transaction-based fees, marketing opportunities, and other promotional value. In addition to this, commitments on credit card arrangements often are unilaterally cancelable by the issuer at any time. With this in mind, for the purposes of investor information, ABA believes that determining a fair value for standby letters of credit (SLOC) or for unfunded loan commitments is, in general, fraught with the same pitfalls as the fair value of the loan itself.
>
> For most SLOCs or unfunded commitments on loans or that are not held-for-sale (for example, for revolving corporate credit lines), there is normally no active market – bid and ask spreads are significant when they are traded, so the reliability of such estimates is often significantly reduced. Further, the relevance of such information is negligible, since any fair value changes will not be recognized as cash flows to the bank. With such questionable reliability and relevance, bank capital, one of the most critical elements in analyzing bank performance and risk, should not be subject to changes in the fair value of any unfunded loan commitments.

[20] As noted in the cover letter, the answers to these questions refer to the classification and measurement of financial assets and liabilities. The remaining issues in the ED and the answers to the questions relating to those issues will be covered in a separate comment letter.

Question 4: The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity's consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?

> **<u>Response</u>**: ABA disagrees that an investee's operations must be related to that of the reported entity in order to obtain equity method accounting for equity securities. Securities related to many private companies have no active market and, in fact, entities that financial institutions often invest in have no profit motive. Examples of these entities are housing cooperatives and low income housing entities. In fact, most low income housing entities are formed specifically for tax benefits provided to investors. In these cases, the investee operations are not likely to be sufficiently related to the investor. Fair values of such securities do not faithfully represent the value to the investor, who must often hold these restricted securities for many years to avoid a recapture of tax benefits.
>
> ABA also disagrees that all equity securities not accounted for through consolidation or through the equity method (and currently accounted for using the cost method) should be accounted for at fair value. Estimating fair values for most non-marketable securities is a process that will be bereft of timeliness and precision. Often, reliable financial information in which to base fair value estimates is not available for several months after a period-end. Further discounts for liquidity of these investments will provide bid/ask spreads that put reliability of such values into further doubt.

<u>Initial Measurement: For All Respondents</u>

Question 8: Do you agree with the initial measurement principles for financial instruments? If not, why?

> **<u>Response</u>**: See responses to questions 9 through 11.

Question 9: For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

> **<u>Response</u>**: ABA believes that the transaction price should be the measurement principle for all such transactions and cautions that, due to the cumbersome requirement to determine whether there is reliable evidence of a significant difference between the transaction price and fair value, significant implementation issues will drive up operational and audit costs. Volatility in interest rates and credit and liquidity discounts will require an analysis of loan fair values on a virtually continuous basis. Maintaining documentation to support the difference between the current fair value and the transaction will be overly burdensome. In the end, we believe this requirement may provide little, if any, value to the user of the financial statements.

Further, in addition to the fact that most commercial loans held for long-term investment are, in fact, transacted in a different market from the one the bank could sell the asset (per paragraph 16 b. of the ED), determining the fair value itself will be problematic. The majority of loans in the non-residential mortgage market have no active secondary market, and pricing for many loans is also based on factors that are not recognizable within the current definition of "fair value" of a loan. Namely:

- Loans terms are often based on a bank/borrower relationship that transcends financial terms of the specific instrument. Banks can have a holistic view of their customer. Therefore, they may price a loan in relation to other services provided to the borrower, such as transactional account, trust, and other investment management services. The value of these services is not reflected in the financial statements, though they would factor into any valuation for business combination purposes. While the financial instrument (the loan) itself may be issued at a discount to the customer, the financial statements will mislead users if bank performance reflected a decline in operating performance, when, in fact, total future revenues will increase because of the other services.
- Banks that have more underwriting experience with certain industry sectors may enjoy a competitive pricing (interest rate) advantage. However, the fair value of that loan, even if estimated accurately, will not reflect such an advantage.
- Banks that have more efficient servicing processes may enjoy a competitive pricing (interest rate) advantage. However, the fair value of that loan, even if estimated accurately, will not reflect such an advantage.
- Banks may price a loan in relation to other facilities already granted to the borrower. The unit of account may not take that factor into account in determining the fair value.

With all this in mind, the process to determine and support the fair value of the loan at the time of origination is too costly in light of the benefits users are expected to receive. ABA recommends that the transaction price be maintained as the measurement for all transactions of loans and debt securities that are held for long-term investment. If it is the Board's intention (as in Example 1 of the implementation guidance) to segregate marketing subsidies from non-financial subsidiaries, then the final standard should specify this. However, generally maintaining this requirement puts an unrealistic burden on institutions to maintain such supporting documentation.

Question 10: Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income?

If yes, should that principle require initial measurement at the transaction price or fair value? Why?

Response:

ABA supports a single initial measurement principle, regardless of whether the investment will be held for trading purposes or for long-term investment. This will help simplify operational compliance, as well as user understanding, as explained in our response to question 11.

Question 11: Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

Response: ABA supports consistency in recording such costs. Deferring such costs would reflect similar treatment in current GAAP for loans held for sale and loans held for investment, while expensing them reflects how such transactions are treated under the fair value option.

From a user perspective, ABA is concerned that immediate expensing of costs will not reflect the true performance of the trading operation, as gains and losses will not reflect the direct costs of those transactions. These costs are normally presented as administrative expenses. Further confusing this issue is the diversity in practice of securities dealers to charge a separate commission for certain transactions (such as equity trades), yet embed such a charge within the bid/ask spread for others (such as fixed-income trades).

This is in contrast to the yields that are presented net of the direct fees and costs that were deferred. In other words, the costs are included in one business strategy and excluded in the other. We believe this will provide less meaningful information to the financial statement users if they are comparing performance by business strategy.

Operationally, we believe it is much simpler for a bank to treat all originated and purchased assets the same at the time of origination or acquisition. Often, because of changing data supplied by the borrower through the underwriting pipeline, banks may need to change how they expect to manage the asset. Therefore, accounting for such costs consistently will help avoid the confusion that often accompanies the pipeline process. Our operational concerns are also geared toward whether GAAP versus tax accounting differences are necessary. If there is no compelling reason in financial reporting to create a GAAP/tax difference, then we believe that such a difference should be avoided.

<u>Initial Measurement: For Preparers and Auditors</u>

Question 12: For financial instruments initially measured at the transaction price, do you believe that the proposed guidance is operational to determine whether there is a significant difference between the transaction price and fair value? If not, why?

> **<u>Response</u>**: ABA believes more examples of why the transaction prices may be significantly different from the fair value should be included. Further analysis may also be required within the examples noted. For example:

- In the commercial loan market, it is likely that the fair value of a loan, which is based on the exit price within an illiquid secondary market, is significantly different from the issued loan pricing. More guidance is required to evaluate and audit such differences expected within paragraph 16b.
- In a competitive bid environment, more examples are needed to determine how other differences should be evaluated, as well as how the related pricing should be evaluated. For example, if two companies bid significantly lower rates in a bid process that includes five lenders, do the lower rates constitute fair value?
- In Example #1, competition in the auto industry results in wide variations in loan rates on a period by period basis. Therefore, more practical guidance is needed. For example, could the fair value of a loan change on a day-to-day basis merely because the competition has responded to initial incentives offered by the company?

<u>Subsequent Measurement: For All Respondents</u>

Question 13: The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views.

Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

> **<u>Response</u>**: The default measurement for financial instruments should not be fair value, and unreliable fair values should not be provided on the face of the balance sheet. The entity's business model dictates how performance is measured and how it manages its capital.
>
> There are some that believe that all financial decisions are based on fair values. . However, banks in the U.S. do not operate in that realm. Therefore, such an assumption is based on three faulty hypotheses:

1. Fair values for financial instruments are reliable: Daily volatility of debt security prices during the recent financial crisis has demonstrated that fair values can often be unreliable as a measure of corporate performance. Uncertainty and illiquid markets rather than financial instrument performance contribute to this. While volatility in the financial statements is not to be avoided when applicable, unnecessary volatility is, since significant portions of such volatility were not due to credit, but due to a liquidity concerns as the once-liquid markets dried up. In other words, the volatility was not related to the underlying credit quality. If banks are in the business of managing underlying credit quality, bank performance and bank capital should not be measured by the unrelated market forces.
2. There is an active market for all financial instruments: The plain truth is that, for the majority of all non-residential mortgage loans, there is no active market. As a result, not only are estimates subject to questionable quality (see hypothesis 1 above) but, as a result, there is normally no effort whatsoever by a banking institution to realize a loan's estimated fair value. Those who believe that banks react to fair value changes by selling individual loans are sorely mistaken. Banks make financial decisions on these loans not based on a fair value, but by the cash flows they believe they will collect. For a loan's principal balance, this value is the amortized cost, less a loan loss reserve. However, if the ED becomes final, then we believe it is inevitable that banks will react to the new accounting model by changing their product mix and approach to banking.
3. There is an infrastructure where fair value can be reliably estimated if required: Outside of the residential mortgage securities market, most loan terms and collateral arrangements are unique – there is no standardization in these markets and, thus, no basis to believe a "market" rate for those terms is credible. Further, independent appraisals of collateral are normally updated on less than a quarterly basis. With this in mind, it is apparent that any fair values that are estimated are based on unreliable data assumptions.

With this in mind, the default measurement attribute should be based on the business model and strategy used in managing its different books of business.

Question 14: The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?

Response: For those financial assets that, because of a bank's business model, are not held for trading purposes, but are held primarily for long-term investment, fair value changes should be recognized in neither net income nor in other comprehensive income. These changes are not relevant to the operation or management of the traditional commercial bank and, thus, should not be included on the face of a financial statement. Such information is appropriate only for footnote disclosure.

ABA also notes that, for the purposes of general clarification, those items that are recognized in net income under the proposed accounting model (interest income and expense, credit impairments and reversals, and realized gains and losses) do not represent fair values, but represent actual past and estimated future transactions affecting cash flows.

Question 16: The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?

Response: Reclassifications should be allowed in certain circumstances. Business strategy changes occur in the natural course of business through a deliberate and thoughtful process, and the accounting should reflect this change. Of course, an example of this is in the event of a business combination, but may also include strategic changes in the markets an institution serves.

Further, companies that originate loans may often execute master commitments sales agreements to sell loans to government-sponsored enterprises at prices based on volume during a specified period. In certain situations, the sales agreements are cancelled and the loans may then be held for long-term investment. This normally occurs within the first three months after origination. In these situations, where management's strategy to hold the instrument has changed within the first few months subsequent to origination/acquisition and because of unusual circumstances, reclassification should be permitted.

Question 17: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in cost-to-service rate over the implied maturity of the deposits.

Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

Response: ABA believes the proposed measurement approach for core deposits is theoretically appealing by helping to repair a flawed fair value model; however, there is significant concern among our members about this model. First, the overall accounting model (whereby all financial assets and liabilities are recorded at fair value on the balance sheet) does not comply with our recommendation to account for loans and debt securities held for long-term investment, as well as the related liabilities, at amortized cost. We have provided reasons for our position elsewhere in this document.

Second, the measurement approach is not consistent with the overall accounting model that has been proposed in the ED nor is it consistent with the model that is currently used in business combinations – fair value. While the Board has acknowledged there is value in core deposits that may be separately measured, one of the most significant aspects of this value – the marketing value of the customer accounts – is specifically excluded from consideration. As a result, core deposits will be subject to two different accounting models: one for business combinations and another for "remeasurement value" of financial instruments.

Third, ABA believes that the present value measurement approach will further decrease comparability of capital among financial institutions. The key assumptions of implied maturity, all-in-cost-to-service rate, and alternative funds rates will be subject to wide ranges and interpretations. These assumptions have, for most banks, not truly been subject to audit and, from an accounting perspective, are not evaluated on a regular basis. Further, these assumptions have never been derived by most individual banking institutions on any kind of regular basis. So, the operational costs to begin this process may be significant.

Fourth, if the Board is concerned with reflecting asset-liability duration mismatching, we believe that any one specific present value approach is inappropriate. Interest rate risk management is performed using a variety of methods and includes various stress testing over a range of future interest rate and curve assumptions. If there is concern regarding the asset-liability mismatching, we recommend that such qualitative information be required only in Management Discussion and Analysis sections, as liquidity management is a separate issue from financial statement performance.

Most important, however, we question whether the benefits will exceed the significant costs to prepare and audit this information. We are aware of no investor (or any other user) interest in such core deposit information as defined in the ED. In fact, what they do understand about core deposit intangibles may need to change under the ED. While we believe the desires within the investment and banking communities were to reduce complexity within accounting for financial instruments, this significantly adds further complexity, both operationally and conceptually.

While ABA has historically supported the idea of using the same measurement basis for assets as the liabilities that fund them, we recommend that significantly more research be performed to analyze possible procyclical effects of requiring the value (whether fair value or present value) of core deposit intangibles in the event of systemic economic stress.

Specifically, the countercyclical effect of the core deposit intangible (CDI[21]) is assumed to occur in relation to a portion of interest rate volatility. However, procyclical moves in CDI may result in recessionary times and general economic stress. Since the new CDI estimates have never been subject to audit, we foresee practical questions arising, including:

- Should bankers assume that depositors are sensitive to the bank's financial position so that declines in asset quality will result in decreasing (or completely eliminating) the implied

[21] While the ED refers only to "core deposit liabilities", the alternative model views presented in the ED refer to this as a "core deposit intangible", which conforms to general industry practice.

maturity time period? If so, then the procyclical nature of recording assets at fair value will be exacerbated by the recording of the CDI.

- Should bankers assume that regulatory agencies, such as the FDIC, will provide backstops as they did recently to prevent depositor panic? If not, then the procyclical nature of recording assets at fair value will be exacerbated by the recording of the CDI.
- Will declines in asset values at a bank result in a tightening in the spread between the alternative funds rate and the all-in-cost-to-service rate? If so, then the procyclical nature of recording assets at fair value will be exacerbated by the recording of the CDI.
- In an environment of general economic stress, is it reasonable to assume that all alternative funding sources will actually be available? If not, then the procyclical nature of recording assets at fair value will be exacerbated by the recording of the CDI.

ABA also believes that the Board should reevaluate the requirement of recording the CDI in light of the project as a whole, which was undertaken to address financial instruments, and not intangibles. By creating a new accounting model for intangibles (present value for internally generated core deposit intangibles), the Board may be opening the door to revise accounting principles for all internally generated intangibles. With this in mind, we recommend that a more comprehensive project on intangibles be conducted before CDIs are required to be recorded.

In any event, if this portion of the ED is adopted, more transition guidance will be required regarding how to treat the currently recorded deposit intangibles (which are based on a comprehensive fair value concept and amortized) in light of the new CDI (which is limited and not amortized).

Question 18: Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?

Response: The Board should be aware that measurement attribute mismatches will naturally occur based on the proposal to record all loans on the balance sheet at fair value. Such a mismatch is further complicated because deposit liabilities are not normally managed based on fair value. Indeed, depositors would be astonished to realize that financial statements would measure their funds at amounts less than the amount of their deposits.[22]

Given all this, ABA recommends that both financial assets and liabilities be recorded on the balance sheet based on their business model, and companies should be permitted to record financial liabilities at amortized cost based on how the corresponding assets are managed. Based on this, liabilities (including deposits) that fund assets managed at amortized cost should be measured at amortized cost.

[22] Depositors are extremely important "users" of bank financial statements. ABA is also concerned about the reactions of depositors who may not understand the recording of present values of CDIs when the values reported are less than the amounts owed.

Question 19: Do you believe that the correct financial instruments are captured by the criteria in the proposed guidance to qualify for measurement at the redemption amount for certain investments that can be redeemed only for a specified amount (such as an investment in the stock of the Federal Home Loan Bank or an investment in the Federal Reserve Bank)? If not, are there any financial instruments that should qualify but do not meet the criteria? Why?

> **Response**: Yes. An investment that has an agreed-upon redemption amount should be measured at the redeemable price. Such investments have no real value other than par, since transfers may occur only with approval of the issuing organization and for the stated price.

Question 20: Do you agree that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income in combination with other deferred tax assets of the entity (rather than segregated and analyzed separately)? If not, why?

> **Response**: ABA does not support a requirement that the entity's entire tax position should be assessed when evaluating the valuation allowance. Such an approach adds complexity to an already-complex issue – fair value changes to assets that are recorded but, since the assets are being held for long-term purposes, are unlikely to be realized. To require that these deferred tax assets be analyzed along with the rest of the entity is to imply that it is probable that the related gains or losses will be realized, which is misleading.

Question 21: The Proposed Implementation Guidance section of this proposed Update provides an example to illustrate the application of the subsequent measurement guidance to convertible debt (Example 10). The Board currently has a project on its technical agenda on financial instruments with characteristics of equity. That project will determine the classification for convertible debt from the issuer's perspective and whether convertible debt should continue to be classified as a liability in its entirety or whether the Board should require bifurcation into a liability component and an equity component.

However, based on existing U.S. GAAP, the Board believes that convertible debt would not meet the criterion for a debt instrument under paragraph 21(a)(1) to qualify for changes in fair value to be recognized in other comprehensive income because the principal will not be returned to the creditor (investor) at maturity or other settlement.

Do you agree with the Board's application of the proposed subsequent measurement guidance to convertible debt? If not, why?

> **Response**: ABA disagrees that convertible debt will automatically require fair value changes to be recorded through income. While we believe that the criteria for classifying such an instrument is not inappropriate, we believe that terms (for example, certain call/put features) in many convertible debt issuances will cause the principal to, in fact, be returned to the investor/creditor at maturity or other settlement. Therefore, we believe that such treatment should be determined on a case-by-case basis, and based on the expected resolution.
>
> Having said that, we recommend that, along with financial assets, financial liabilities, such as

convertible debt, be recorded at amortized cost and not at fair value. We warn the Board that in cases in which convertible debt, under the ED's criteria, is required to be accounted for at fair value with changes recorded through net income, fair value issues related to a company's own credit will emerge. Although theoretically appealing in a fair value model, practically speaking, situations in which net income increases because of a decline in corporate asset quality (and vice versa) do not provide decision-useful information. As noted in our response to question 32, fair value changes to changes in a company's own credit costs should not be reflected in either net income or in bank capital. Unfortunately, because of the proposal to present one statement of comprehensive income, this cannot be avoided, since fair value changes will be reflected in the bottom line performance statement amount.

Subsequent Measurement: For Preparers and Auditors

Question 28: Do you believe that the proposed criteria for recognizing qualifying changes in fair value in other comprehensive income are operational? If not, why?

Response: If the Board proceeds with a fair value model, we agree that certain fair value changes should be included in net income while others are included in other comprehensive income. The proposed criteria for recognizing changes in fair value in other comprehensive income is generally operational, with the exception of loans and debt securities that are purchased at a substantial premium over the amount at which they can be prepaid. While this criterion has developed in practice with some large institutions since EITF 99-20 was issued, there is no clear practice as to what that "substantial premium" level is. Determining that specific level will present challenges, as the likelihood of the individual loan prepaying (and, thus, causing a loss) can vary on a borrower-by-borrower basis and often can depend on, among other things, other loans that the borrower has outstanding. These assets can often be managed for the collection of contractual cash flows, so not only does the criterion present operational issues, but the criterion contradicts the general spirit of the business strategy criterion. With this in mind, we recommend that this criterion be excluded from the final standard.

Question 29: Do you believe that measuring financial liabilities at fair value is operational? If not, why?

Response: From a cost/benefit perspective, we do not believe measuring financial liabilities at fair value is operational, nor do we believe measuring financial assets at fair value is operational. Given the concerns expressed with the core deposit intangible and the issues with fair value changes in an entity's own credit, we believe that the work required to measure financial liabilities at fair value will not be at all cost effective and may, in the end, provide information that hinders banking analyst efforts to predict the cash flows of a banking entity.

If the Board moves forward with this project, it is important to work further with industry to determine whether financial liabilities should be reported at market. If one assumes that all financial instruments should be accounted for at fair value, this treatment is consistent with that notion, but many banks believe it will only add to the confusion that the ED will bring.

Question 30: Do you believe that the proposed criteria are operational to qualify for measuring a financial liability at amortized cost? If not, why?

> **Response**: Due to the way that many institutions manage their assets and liabilities, we believe there will be limited situations in which a banking entity will qualify for such an option.

Question 31: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in cost-to-service rate over the implied maturity of the deposits.

Do you believe that this remeasurement approach is operational? Do you believe that the remeasurement approach is clearly defined? If not, what, if any, additional guidance is needed?

> **Response**: There are significant operational challenges related to measuring the core deposit intangible. In addition to the fact that for most banks these amounts are not generally estimated or subject to audit (nor to the required internal controls as per the Sarbanes-Oxley Act), it is difficult to determine the actual cost to implement such a system. It is true that certain present value information may be currently derived from interest rate risk management reports already performed by banks for regulatory purposes. However, unique, entity-based maturity and funding cost assumptions are not often used.
>
> In addition to the issues noted on question 17, additional guidance that will be required includes:
>
> - How will banks account for core deposit intangibles (CDI) recognized upon business combinations/acquisitions, as opposed to the ongoing CDI within this ED?
> - If there will be a change to the accounting for acquisition-related CDI, will there be a transition period in which such a change may be implemented?
> - Should hedging costs be included in the interest rate spread assumptions?
> - Since alternative funding may come from a variety of sources, how much documentation regarding the availability of such sources will be required when subject to audit?
> - How can future expectations regarding future alternative funding costs be used? Should the use of forward interest rate curves be utilized when making assumptions regarding alternative funding in the future?

Presentation: For All Respondents

Question 32: For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB's tentative decisions on financial liabilities measured at fair value under the fair value option? Why?

> **Response**: ABA agrees with the many investors who believe that recognizing gains due to declines in an entity's own credit rating does not provide decision-useful information. The recognition of gains in such a situation also appears to contradict the going concern principle. Thus, ABA supports efforts to separately identify such amounts. While we support recognizing such unrealized gains through other comprehensive income (OCI) in any situation, ABA also cautions that the impact of recognizing these gains through OCI is muted, due to the proposal to require one continuous statement of comprehensive income. Such gains, if the proposals are adopted, will still be reflected in a bottom line number that will likely be the focus of many users of financial statements.
>
> As a result, we believe that such fair value information related to a company's own debt (whether applied to its own credit rating or the credit costs applied to its industry in general), not only blurs transparency, but directly masks it. Both good and poor financial performance will be distorted – even contradicted – by these marks. This is the inevitable result of full fair value accounting.

Question 33: Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in the entity's credit standing (excluding the changes in the price of credit).

What are the strengths and weaknesses of each method?

Would it be appropriate to use either method as long as it was done consistently, or would it be better to use Method 2 for all entities given that some entities are not rated?

Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity's credit standing, excluding the price of credit? If so, please explain why those methods would better measure that change.

> **Response**: ABA supports providing an option to use any method, as long as it is performed consistently, with appropriate disclosure as to the method. With this in mind, measuring credit and debt value adjustments is an evolving process and we believe that neither option that is presented reflects how banks or investors measure credit risk. In short, market participants do not normally separate entity-specific credit risk valuation from credit spreads. In fact, doing so would be extremely difficult. Therefore, issuing a final standard that advocates either method will present both conceptual and operational challenges.

Question 34: The methods described in Appendix B for determining the change in fair value of a financial liability attributable to a change in an entity's credit standing (excluding the changes in the price of credit) assume that the entity would look to the cost of debt of other entities in its industry to estimate the change in credit standing, excluding the change in the price of credit. Is it appropriate to look to other entities within an entity's industry, or should some other index, such as all entities in the market of a similar size or all entities in the industry of a similar size, be used?

If so, please explain why another index would better measure the change in the price of credit.

> **Response**: Subject to our answer addressing question 33, ABA supports not limiting the principle that is intended to merely estimate a cost differential from a peer group. Individual banks have differing funding strategies and geographic reach. Therefore, their basis for one index or another may appropriately differ.

Disclosures: For All Respondents

Question 65: Do you agree with the proposed disclosure requirements? If not, which disclosure requirement do you believe should not be required and why?

> **Response**: Due to our opposition on how interest income is calculated in the ED (which we detail our opposition in our separate comment letter on loan impairment), ABA opposes the disclosure requirements in paragraph 102 and 103, which are required only because of the proposed method change.

Disclosures: For Preparers and Auditors

Question 68: Do you agree with the transition provision in this proposed Update? If not, why?

> **Response**: ABA believes more transition guidance is required regarding a number of different areas:
>
> - Guidance must address any restatement of the core deposit intangible that may be needed due to the different valuations used on an ongoing basis under this ED versus the valuations currently used for business combinations and similar acquisitions.
> - There will be needed disclosures in the likely circumstances of a business combination where fair values of assets and liabilities are significantly different than those recorded prior to the transaction.
> - Since new financial assets are being recorded and some are being measured on a different basis (for example, loans have never been recorded at fair value and many unfunded loan commitments have never before been recorded on balance sheet at all), more guidance is required to determine whether a bank will qualify for the deferral. Further, changes that occur as a result of convergence with IFRS (for example, the IASB's Derecognition project) or as a result of new standards (for example, in lease accounting) will also need to be explained as to their impact on the deferral scope.
> - If the Board really believes that smaller, non-public entities need an increase in sophistication in order to adequately comply with the proposed standards, then more

guidance regarding determining fair values is required in order to ensure an adequate learning curve is achieved during this transition process.

Question 69: Do you agree with the proposed delayed effective date for certain aspects of the proposed guidance for nonpublic entities with less than $1 billion in total consolidated assets? If not, why?

Response: ABA supports a delayed effective date for smaller entities. This will provide community banks, which comprise approximately 90% of the nation's banks, with additional time to learn from the larger banks and develop the extensive and costly processes to provide the fair values that are being proposed.

However, without a proposed effective date, we cannot determine how long that delay should be. We are recommending at least four years between issuance of the final standard and the implementation date for larger companies. If part of the goal is for the smaller companies – and the accounting firms – to learn from the larger entities, then a four year delay is probably not sufficient. We would recommend three additional years after the post-implementation review has been done and there is confidence with the systems, processes, personnel, and audit firm education.

Further, if the Board believes that a post-implementation review is necessary to determine that the rest of the 90% of financial institutions should then comply with the remaining guidance, we question whether the Board itself believes sufficient due process has been conducted to give reasonable assurance that compliance can be achieved in a cost-effective manner. From a practical perspective, therefore, such a deferral appears to equate to a field test. However, to perform a "live" and "public" field test on an accounting standard that has significant procyclical impact and lacks an improvement in transparency could well be dangerous because of its anticipated systemic impact.

It has been noted that because of the level of sophistication at smaller, non-public institutions, extra time is required in order to gain experience in estimating fair values in accordance with "exit price" methodologies. We do not question whether experience is required. However, we question how critical such experience will be to the stakeholders in these banks and whether the larger bank implementation of the ED will give the Board a basis for concluding whether smaller institutions should comply.

<u>Effective date and Transition: For Preparers and Auditors</u>

Question 70: How much time do you believe is needed to implement the proposed guidance?

<u>Response</u>: It is difficult to estimate the amount of time that will be needed to implement the proposed rules, for many reasons, a few of which are:

- New computer systems need to be developed and tested for all sizes of banks.
- Bank personnel need to be trained.
- Auditors need to be trained.
- Internal controls processes need to be developed and tested.
- Companies need to understand whether there will be auditing changes as a result of the standard and whether those changes have an impact on internal controls processes and management reports on internal controls.

We believe those banks for which the four year deferral does not apply will need a minimum of four years after the release of the final standard. The four year deferral would also need to be extended for the smaller banks, so that they can build on what the larger banks and their auditors learn from their implementation.

Question 71: Do you believe the proposed transition provision is operational? If not, why?

<u>Response</u>: ABA believes that the transitional provision for a cumulative-effect adjustment to the statement of financial position, while operational, presents challenges. Namely, key metrics (for example, net interest margins) and bank capital will not be comparable to prior years. Indeed, bank capital may often reflect deficits because of the requirement to use fair values upon conversion. Therefore, historical data will likely be desired by users who perform analyses. While we are not suggesting that this be required, some entities may choose to provide supplemental (and perhaps, unaudited) data for years prior to the implementation date. With this in mind, though presenting problems, we do believe the provision is operational.