

September 21, 2012

Leslie Seidman, Chairman  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116  
Via email: [director@fasb.org](mailto:director@fasb.org)

RE: File Reference No. 2012-200: *Disclosures about Liquidity Risk and Interest Rate Risk*

Dear Chairman Seidman:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Exposure Draft: *Disclosures about Liquidity Risk and Interest Rate Risk* (ED). ABA brings together banks of all sizes and charters into one association. ABA represents banks of all sizes and charters and is the voice for our nation's \$14 trillion banking industry and its two million employees.

Bankers generally agree that the major business risk banking institutions face is credit risk. Having addressed credit risk disclosures in Accounting Standards Update 2010-20 (*Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*), the FASB has issued the ED in order to provide decision-useful information about an entity's liquidity risk and interest rate risk through qualitative descriptions and standardized quantitative tables. Liquidity risk and interest rate risk are the key business risks, outside of credit risk, faced by banking institutions and significant resources are normally deployed, by both bankers and banking regulators in addressing, analyzing and evaluating these risks. Indeed, two major aspects of the supervisory CAMELS rating system<sup>1</sup> are liquidity risk ("L") and sensitivity to market risk ("S").<sup>2</sup> In addition to separate procedures performed by bank examiners to address liquidity and interest rate risks, certain related disclosures are required to be included in bank Call Reports. Further, for publicly-held institutions, significant disclosures related to liquidity risk and to interest rate risk are already required within the Management's Discussion and Analysis (MD&A) section of their public filings.<sup>3</sup>

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<sup>1</sup> The CAMELS system is one of several risk rating systems used by U.S. banking agencies. As part of their supervisory framework, the CAMELS system is focused on evaluating risk, identifying material and emerging problems, and ensuring that individual banks take corrective action before problems compromise their safety and soundness. The CAMELS ratings are required by law to be confidential, and are open only to bank management and directors.

<sup>2</sup> Market risk generally includes risks related to changes in interest rates, foreign exchange rates, commodity prices, and equity and other security prices.

<sup>3</sup> In addition to quantitative and qualitative information required as part of the Securities and Exchange Commission (SEC) Industry Guide 3 for bank holding companies, specific market risk disclosure rules are required under Regulations S-X and S-K.

We recognize the need for investors to understand liquidity and interest rate risks. However, we are concerned about several aspects of the ED, and we believe that the required information will not achieve an improvement in financial reporting. In addition to our specific detailed recommendations related to individual proposed tables, we urge the Board to consult with SEC, banking agencies, and the banking industry as to the appropriate level and format of disclosure, as well as the appropriate medium (whether in Call Reports, SEC disclosures, or GAAP footnote disclosures) in which it is presented. As proposed, the benefits derived from the required information will be small, compared to the newly borne costs required to present and audit such information. With this in mind, it is important to exclude community banking organizations from the scope of the ED, due to the cost of compliance.

Our overall concerns are:

- The appropriate level of disclosure must be carefully considered. Bankers question whether certain liquidity-related information should be provided to the general public. Such disclosure, if misinterpreted, can lead to irreversible pressure not only on the specific bank, but on the banking system in general.
- Existing regulatory disclosures already provide relevant liquidity and interest rate risk information. Much of the quantitative information required in the ED can already be accessed through review of information in existing Call Reports and 10-K and 10-Q disclosures, thus providing little or no improvement to financial reporting. Additionally, we believe the forward-looking nature of information related to how banks manage liquidity and interest rate risk (for example, through stress testing and other simulations) is appropriate only within MD&A and not within an audited financial statement.
- Certain required information is not relevant to bank risk management practices. While the newly required information may, at times, complement existing regulatory disclosures, they generally do not add incremental decision-useful value to the disclosures. In fact, information required in certain of the proposed standardized tables is not relevant to existing risk management practices and, thus, can distort the related risks of the company.

### **The Appropriate Level of Disclosure Must be Carefully Considered**

Bankers are concerned that data – accurate or inaccurate – regarding bank liquidity can be misinterpreted, causing adverse and irreversible consequences to individual organizations as well as to the banking system. With the proposed standardized information, peer analysis can be performed quickly, revealing “most” and “least” liquid institutions; however, it is based on arbitrary criteria and is unreliable. Additionally, “least liquid” could be misinterpreted to mean illiquid. As noted in more detail later in this letter, much of the information in the proposed liquidity gap analysis table does not reflect how banks manage liquidity and would, thus, feed erroneous conclusions. Even if an analysis could accurately indicate lower liquidity levels at a point in time relative to peers, such an analysis would not take into account what management is doing to mitigate the risks (or has already done by the time the financial statements are filed), nor

would it necessarily take into account the institution's absolute liquidity. In the banking system, the proverbial "run" on an institution can happen quickly and can spread systemically, without waiting for the correct information from management, auditors, or regulators.

We fear that inaccurate interpretations could cause such problems for institutions that, while ranking relatively low against peers, have sound liquidity positions on an absolute basis – including according to detailed regulatory reviews. With this in mind, we recommend that the Board coordinate with banking regulators to determine the appropriate level of liquidity-related disclosure and to evaluate whether the disclosures would be misleading. If Basel III becomes a requirement in the U.S., some additional public disclosure of liquidity is likely. Even if the U.S. does not adopt Basel III, we believe guidance from the regulators could be very useful in determining the appropriate level of disclosure.

### **Existing Regulatory Disclosures Already Provide Relevant Liquidity and Interest Rate Risk Information**

Banks routinely publicly provide qualitative and quantitative disclosure related to liquidity and interest rate risks (among other risks) in Call Reports, which contain certain repricing and maturity data for loans,<sup>4</sup> securities,<sup>5</sup> and deposits. Additionally, within 10K and 10Q filings of publicly-held institutions (in compliance with the Securities Act Industry Guide 3 – Statistical Disclosure by Bank Holding Companies), various schedules addressing these risks are presented, including average yields earned on assets and rates paid on deposit liabilities and short-term borrowings, as well as loan balances presented by period of contractual maturity.<sup>6</sup> Guide 3 also requires disclosure of average and maximum amounts outstanding for short-term borrowings.<sup>7</sup> Further, MD&A disclosures are intended to provide investors with guidance relevant to how these risks are managed and, as it relates to interest rate risk, the extent of exposure to various interest rate changes, using scenarios that management believes are reasonable. The MD&A requirements do not prescribe how management must communicate this information, which is important, as it allows management to utilize and present information it actually uses to monitor and manage these risks.

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<sup>4</sup> The data reported are generally split between first lien single family residential mortgage loans and all other loans. Banks with under \$300 million in total assets that do not have loans to finance agricultural production and other loans to farmers exceeding 5% of total loans are generally exempt from reporting loans by repricing/maturity date.

<sup>5</sup> The data reported are generally split between first lien single family residential mortgage pass-through securities, other mortgage-backed securities, and other debt securities. Required reporting of securities excludes investments in trading securities, as well as mutual funds and other equity securities with readily determinable market values. While not common, there are certain banking institutions that maintain investments in mutual funds that invest in debt securities.

<sup>6</sup> While not detailed in Guide 3, long-term debt and operating lease payments also are generally required to be reported by similar contractual reporting period.

<sup>7</sup> SEC Release No 33-9144 *Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis* also emphasizes that disclosure related to repurchase transactions that are accounted for as sales is required.

Risk management processes related to liquidity and interest rate risk involve regularly-performed forward-looking stress tests, using various assumptions. We recognize that forward-looking assumptions are often used in preparing certain portions of the financial statements (e.g., fair values). However, many of the disclosures proposed in the ED (specifically, as they relate to certain information in the bank repricing analysis and the interest rate sensitivity table) require significant amounts of forward-looking information (not only forward-looking assumptions to determine current period values, but also projections of forward-looking results of the entire entity). This level of uncertainty is appropriate only for inclusion in MD&A and not in audited financial statements.

Finally, given that the management of liquidity risks and interest rate risks involves forward-looking estimates not necessarily linked to financial statement line items (for example, the future decay of deposit liabilities or the future conversion to cash of liquid assets), the new internal control monitoring processes and/or audit procedures needed to comply with the requirements would be significant. We are not aware of any problems with the inclusion of the information presented in the MD&A and, thus, question why such information must be part of GAAP.

With this in mind, we see no significant improvement in financial reporting being achieved through the requirements in the ED, especially given the costs that will be required to develop and monitor financial reporting controls for the related assumptions and to audit the related assumptions. Therefore, we recommend that discussions with SEC staff be conducted to determine whether existing MD&A disclosures need improvement (subject to our comment below) to assist investors in analyzing these risks.

### **Certain Required Information is Not Relevant to Bank Risk Management Practices**

We are concerned that the ED attempts to codify existing regulatory disclosures into GAAP in inappropriately standardized formats. We understand that the Board believes the proposed requirements provide incremental, complementary information to what is already disclosed in public filings. However, the proposed liquidity gap analysis and the repricing analysis are standardized tables that are required to be prepared on a basis that differs from how banks monitor and manage the respective risks, and thus how banks inform users about these risks within the MD&A. Because the proposed disclosures are based upon information management does not use, this will likely result in confusion among investors as to what management actually does use. For the limited amount of information required in the ED that is utilized by management, more sophisticated and instructive information is, nevertheless, provided through MD&A and Guide 3 disclosures. Therefore, we do not believe the required tables will be relevant and in fact, could potentially confuse and/or mislead financial statement users.

Therefore, as is discussed below in more detail related to the proposed tables, we recommend the FASB engage the SEC in clarifying what is appropriate for inclusion in Guide 3 and MD&A, and if the concern is primarily around comparability, the SEC could consider providing further instruction to achieve this goal. Since the vast majority of banking institutions are privately-owned, similar discussions should be held with banking regulators, who perform separate detailed reviews of liquidity and interest rate risk management as part of their supervisory

responsibilities.<sup>8</sup> Avoiding confusion by eliminating redundancy in data should be a priority for the regulators, while sparing privately-held organizations unnecessary costs of compliance.

### **Concerns about Individual Tables in the ED**

The remainder of this letter describes how bankers generally manage liquidity and interest rate risks, provides observations on specific requirements of the ED, and provides recommendations as to how investors can obtain the appropriate information in a cost-beneficial manner.

### **Liquidity Risk Disclosures**

#### **Liquidity Risk Management at Banks**

Bankers generally manage liquidity risk to ensure they have the liquidity available to satisfy their existing customer base (including paying off maturing deposits, funding withdrawals, and satisfying loan commitments) and to enable them to grow their core businesses. Methods used to manage liquidity risk are subject to bank policies that are reviewed and approved by the related committee of the board of directors. Diversifying funding sources, testing short and medium term adequacy under stress scenarios, and holding sufficient cash and readily marketable assets are commonly used methods for addressing liquidity risk. Liquidity modeling performed by banks is dynamic and considers run-off and origination of assets (including renewal of maturing loans) and liabilities, using various assumptions related to how quickly certain assets can be sold or pledged to provide liquidity.

Banks typically diversify their deposit liabilities between wholesale and retail depositors, varying the lengths of maturities and market concentrations. It is generally assumed that retail deposits are more stable, being less sensitive to interest rate changes and market volatility, though certain wholesale deposits may exhibit similar (and, in some specific cases, superior) patterns of retention.

In addition to issuing long-term debt, banks may borrow funds via secured financing (broker-dealers often use secured, short-term financing) through repurchase agreements, where unencumbered liquid assets in a company's portfolios (available-for-sale and held-to-maturity) may be used as collateral. Banks also have the capability to access short-term secured financing through advances of the Federal Home Loan Bank and through the Federal Reserve's Discount Window. Banks also commonly maintain unsecured Federal funds lines of credit with other banking institutions.

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<sup>8</sup> *Supervisory Guidance on Stress Testing for Banking Organizations With More Than \$10 Billion in Total Consolidated Assets*, jointly issued May 17, 2012 by the U.S. banking agencies, highlights the importance of stress testing as an ongoing risk management practice. The Guidance specifically refers to effective stress testing, which includes sensitivity analysis, as "forward-looking". While the Guidance specifically relates to banks with more than \$10 billion in total assets, all banks are subject to examination of their liquidity and interest rate risk management.

A bank's funding capacity, including its ability to access the capital markets and its ability to maintain certain collateral levels (for example, related to derivative agreements and margin requirements), is also dependent on its credit ratings. In other words, drops in an institution's credit rating can significantly increase cash and collateral obligations (in addition to the direct increases in the cost of unsecured borrowing). Indeed, bankers generally believe that systemic liquidity-related problems are often symptoms of credit-related problems.<sup>9</sup>

### **Stress testing and Basel III**

Bankers use certain ratio analyses to provide general indications of their liquidity, for example, loans to assets, loans to core deposits, purchased funds to total assets.<sup>10</sup> However, in addressing the liquidity risk objective in the ED – whether they can satisfy cash obligations when needed – bankers would be required to perform liquidity stress testing. Liquidity stress testing is currently performed by banking institutions under various scenarios, including changes in local or national economic conditions, changes in key funding sources, or changes in individual credit ratings. These stress tests are often performed using various time horizons (monthly, daily, and intraday (when appropriate) timeframes are typical) and are used to quantify the potential impact of specific events and to identify funding alternatives that may be utilized. Such tests are conducted using projected cash flows, including income and expenses, from the related financial assets and liabilities<sup>11</sup>.

The Basel III Liquidity Coverage Ratio (LCR) requires banks to maintain a sufficient level of unencumbered cash and highly liquid securities to meet liquidity needs under an acute 30-day stress scenario. Although the U.S. banking agencies do not yet require Basel III, some banks are currently using the LCR as a stress testing scenario, based on their understanding and expectation of how the proposed rule might be applied.

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<sup>9</sup> Bankers understand that macroeconomic and specific market dislocation can create loss of liquidity in specific institutions that have not initially experienced deterioration in the credit quality of their assets. However, banks that are not well capitalized may also face restrictions related to brokered deposits and in setting interest rates offered to deposit account customers. Therefore, credit risk, and its related impact on capital, has a significant impact on both liquidity and interest rate risks.

<sup>10</sup> These are just a few of the ratios. Such ratios are typically available through information residing in call reports and retrievable, along with many other metrics (e.g., earnings, balance sheet, asset quality, liquidity, and capital), within the Uniform Bank Performance Report (UBPR). The UBPR is produced by the Federal Financial Institutions Examinations Council (FFIEC) on a quarterly basis. For comparable information related to bank holding companies, the Bank Holding Company Performance Report (BHCPR) is produced and based on submitted Y-9 and Y-Q data. Though the target audience for these reports consists of the banks and their banking supervisors, the information is publicly available.

<sup>11</sup> While the stress testing Guidance issued May 17, 2012 applies to banks with over \$10 billion in consolidated assets, *Interagency Policy Statement on Funding and Liquidity Risk Management*, issued March 17, 2010, requires all institutions, regardless of size and complexity, to have a formal contingency funding plan that is regularly tested and updated.

## **Proposed Liquidity Gap Analysis Table**

Under the ED, the liquidity gap analysis generally requires banks to present in tabular format, by prescribed time periods, the expected maturities of each class of financial asset and liability. The ED does not permit the expected maturity of assets to reflect an entity's expectation of the sale or transfer of the instrument, and the balances presented in the table are required to be reconciled to the balance sheet.

The ED notes that the purpose of liquidity risk disclosures is to assist users in assessing the risk that a bank will encounter difficulty in meeting cash obligations. With that purpose in mind, we believe the schedule, as proposed, will have little relevance to reflecting whether and how a bank will realistically meet its obligations. As the schedule is based on a balance sheet carrying value basis, it will not reflect cash received or used during the periods. Further, the expected maturity concept does not truly reflect the bank's expectation with regard to cash flows, thus inaccurately (and inconsistently, among preparers) reflecting and often distorting instruments that prepay. This is because we believe the removal of the entire value based on an average life or based on each time interval will be required, rather than a more smooth and realistic collection of cash flow over time. Conversely, estimates of loans maturing with expectation of renewal will indicate cash inflows that, practically speaking, may not materialize for several years. Further, the requirement to ignore sales of assets is also grossly unrealistic, as it forces the bank to reflect these assets (e.g., mortgage loans held for sale or available-for-sale securities) as liquidity inflows far into the future, whereas the liabilities used to fund these assets often are short-term in nature.

Most important, however, the tables portray a scenario that does not reflect how management analyzes liquidity risk. As noted above, banks manage their liquidity risk through a range of activities, tested under various stress scenarios. The available-for-sale securities portfolio is typically maintained to provide liquidity if and when (however unlikely) it is needed. These securities are not necessarily used for sale, but are (along with held-to-maturity securities) often posted as collateral for short-term borrowings banks use to meet their obligations. So, presentation of expected maturities of many financial assets that are available-for-sale ignores the reality that such assets are held precisely to provide liquidity. Therefore, the proposed table not only is irrelevant to a bank's liquidity – because banks neither use this information nor believe it is useful for managing liquidity risk – it also presents a picture that essentially distorts how a bank manages this risk. Basing an analysis on such a presentation can lead to erroneous conclusions – both favorable and unfavorable – related to a bank's management of liquidity risk.

Furthermore, maturity expectations (as defined in the ED), for the purpose of liquidity risk analysis, is not a concept that we believe faithfully represents management's expectations related to satisfying liquidity needs, since expectations under the various stressed conditions bankers use in their analyses will vary widely, with no specific scenario necessarily adopted by management as "most likely". For example, withdrawal of core deposits under any stressed condition will have no relation to maturity expectations under normal conditions (which we assume is what is required in the ED).

Liquidity stress testing performed by banks covers a wide range of scenarios that are unique to the individual institution and a standardized schedule would not faithfully represent the risks about a bank's ability to satisfy its cash obligations. The proposed table provides no incremental value over a discussion about how the company manages overall liquidity, supplemented by commonly-used liquidity ratios. The proposed analysis, in substance, does not address the objective of the ED. Liquidity becomes an issue to financial statement users in stressed times (credit stress and overall market liquidity stress), and the table does not address such stress. Therefore, we recommend this table be omitted from the final standard.

If the Board desires comparability of a relevant metric of liquidity (beyond the ratios that can be derived from call report data), we believe the Board should coordinate with the current efforts of banking regulators to define what should be considered "high-quality liquid assets" to help maximize comparability between companies (this is described further below).

We understand that some of the more sophisticated financial statement users desire to input certain data into their proprietary models for further analysis and projection. If the Board wants to satisfy these users, we recommend that contractual maturities of financial assets and liabilities be presented, though not in the liquidity schedule, since it would imply that such relationships, in isolation, are critical to liquidity management. For financial assets, requirements from regulatory Call Reports or from Guide 3 can provide an appropriate model. For financial liabilities, we believe IFRS Statement No. 7, which reflects the earliest contractual maturity date (takes into account put or demand options), could be a model for this disclosure. In addition to greatly reducing the cost to prepare and audit such information, financial statement users will be able to apply their own assumptions to pure data to identify liquidity issues. The ED requirements prevent true comparability between banks, since prepayment assumptions will normally be unique to each institution. Our recommended disclosure will be factual, auditable, and can be modeled by financial statement users. With this in mind, we further recommend that all privately-held institutions be exempt from this requirement, since it will merely add to the Call Reports and liquidity management work papers already required by regulators and is unlikely to be used.

### **Proposed Available Liquid Funds Table**

The ED's available liquid funds table requires all entities to present a schedule of all available high-quality liquid assets and borrowing availability. However, the term "high-quality liquid assets" is not defined. We recommend that for banking institutions, this term be defined in coordination with banks and banking regulators in order to provide consistency with how banks will manage liquidity and borrowing lines.<sup>12</sup>

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<sup>12</sup> For example, if the banking regulators require Basel III LCR, it would be useful if the regulatory and GAAP definitions are the same.

## **Proposed Issuance of Time Deposits Table**

The ED's schedule of the issuance of time deposits requires disclosure of time deposits issued and brokered deposits acquired during each of the last four quarters, with the weighted-average contractual rate and contractual life at issuance. We believe that this information can be meaningful in certain circumstances and would not be overly burdensome to produce. However, it is important to note that many institutions have customer deposits that roll-over frequently (sometimes daily). Showing each roll-over as a "new issuance" could reduce the utility of the tables and thus we recommend the Board revisit this if any final guidance is issued. We also recommend that the Board evaluate this requirement with existing Guide 3 disclosures related to deposits and short-term borrowings to determine whether a required disclosure would add significant value to what is already reported.

## **Interest Rate Risk Disclosures**

### **Interest Rate Risk Management at Banks**

Interest rate risk is generally managed by bankers based on their business models and the composition of their portfolios. Large banks with active trading portfolios and/or derivative hedging programs normally address interest rate risk through value at risk (VAR) analysis on the related portion of their portfolio. The VAR is used to estimate potential decline in the related portfolios in which active trading activity can respond to market shock during normal (or historical) market conditions, and is normally closely monitored and reported in MD&A. The VAR estimates concentrate on price/value declines, and, thus, would include other market-related risks besides interest rate risk. In addition to monitoring risks within market-making and client-driven activities, these organizations are hedging certain risks within their retained portfolio (which may include assets that are not recorded on the balance sheet at fair value), mortgage pipeline/warehousing activities, and servicing assets.

In addition to VAR, these portfolios are subject to certain stress testing, though VAR is the primary vehicle in which market risk is managed at these banks.

Non-trading interest rate-sensitive portfolios (including the portfolios in the vast majority of banking institutions, as well as those outside the trading portfolios just discussed that are monitored through VAR) are managed mainly by using various income and equity simulations. Most banks perform sensitivity testing of interest rate changes on net interest income (NII – also often measured as "earnings at risk") and on the present value or market value of equity (models that focus on equity often refer to Economic Value of Equity (EVE) or Duration of Equity). Simulation of NII tends to address shorter term (one to two years) exposure, while simulation of EVE tends to address longer term exposure (over a period of several years). These simulations are primarily used for sensitivity analyses as part of a risk management function. Banks are not managed specifically to maximize current simulated NII or EVE. Rather, their Asset/Liability Management Committee (or other appropriate committee) typically sets guidelines that specify acceptable limits within which NII and EVE may change under various rate change scenarios.

Banks typically use scenarios that can include immediate shocks to interest rates, gradual shocks over a period of a year, as well as flattening and steepening of the yield curve. These scenarios and assumptions can be unique depending on the portfolio makeup of each institution. Further, depending on the sophistication of the organization, this modeling is sometimes performed on a dynamic basis, meaning that interest rate movements are accompanied by detailed assumptions regarding existing business lines, new business, and changes in management and customer behavior. Such assumptions, which often include individualized flattening and steepening scenarios, may be incorporated using progressively sophisticated techniques, such as stochastic-path models or Monte Carlo simulations. Banking regulators have suggested that 300 to 400 basis point shocks provide meaningful stress scenarios in low interest rate environments, such as the environment we have now.

### **Proposed Bank Repricing Analysis Table**

The ED's repricing analysis table requires disclosure of the carrying amounts of financial instruments segregated by time intervals based on the earlier of contractual repricing date or contractual maturity. In addition, expected yield by time period and duration (all by class of instrument) would be presented. Some banks use limited versions of such a table for high level metrics and may disclose their table and/or whether their portfolio is (as would be indicated in such a table) "asset sensitive" or "liability sensitive". However, the analysis gives limited insight into interest rate risk, because of embedded optionality within the assets and the fact that banks frequently use derivatives to manage their interest rate sensitivity.

We believe the repricing analysis table could be useful for smaller, less sophisticated banks that have little, if any, optionality (repricing) in their portfolios or are not actively hedging their interest rate risk. However, we believe the population of such qualifying institutions is very small. For the remaining banks, the period-by-period assessments will often distort their interest rate risk over the long run. For example:

- Repricing data is not relevant for assets or liabilities that are managed with fair values recorded through net income, especially for those organizations that manage interest rate risks (and other market risks not directly related to interest rate risk) through derivatives for which hedge accounting is not used. For example, a fixed rate asset or liability will be classified by its maturity date, whereby its respective hedging instrument may be classified by its reset date.
- Embedded options, including prepayment options, may distort the repricing risk.
- The table does not reflect the risks (and how they are minimized) that are managed through VAR analysis. By presenting all assets and liabilities together, spurious conclusions will be formed.
- Servicing assets/liabilities will not be included in the periodic breakdown, though the financial instruments hedging those risks will. For many institutions, interest rate risk related to mortgage servicing rights (which are not defined as financial assets) is significant.
- Interest rates will often move in a way that makes the repricing dates for many instruments irrelevant.

At its best, considering its limitations, the period-by-period repricing information will merely cause financial statement users to ask the next question: “What is the impact going forward?” Since interest rates are always subject to change, we believe this question is better answered through the stress tests (see our concerns with the proposed sensitivity tests addressed below).

The proposed table also requires duration by each class of financial instrument. We believe the net duration can be a relevant measure of portfolio risk (subject to the limitations that are described above). However, we are very concerned about the operability of such a requirement from the preparers’ and the auditors’ perspectives. While duration is often a relevant factor in determining the recorded value of some items in the financial statements, it is not for instruments that are accounted for at amortized cost (for example, loans, held-to-maturity debt securities, and deposits). Determining duration would have no purpose other than for this specific disclosure. Therefore, calculating duration, especially for customer deposits, will be a new and operationally burdensome process that has never been subject to audit or to the related establishment of internal controls over the process for financial reporting purposes. The assumptions that banks will need to make in order to provide duration will have no “anchor” in the financial statements and, because of the nature of the assumptions, are not likely to be auditable or relevant to the financial statements. We are concerned that the incremental value of this report will not exceed the significant additional costs.

Consistent with our recommendation related to the proposed liquidity gap analysis table, if the Board wishes to provide sophisticated users with data to analyze in their models, the information presented should be limited to the earlier of maturity or repricing dates and should not include duration and yield data. This would alleviate the complications presented by the individualized assumptions that make up yield and duration. We also recommend that the reflected time periods mirror how loans are currently presented within call report schedules. Due to cost/benefit considerations and because the users of privately-held and other community banks’ financial statement users would generally not include the more sophisticated users, they should not be required to provide this data.<sup>13</sup>

### **Proposed Interest Rate Sensitivity Table**

The proposed interest rate sensitivity table requires analysis of changes to net income and shareholders’ equity based on specified hypothetical, instantaneous interest rate changes as of the measurement date for the twelve month period immediately after the reporting date. The sensitivity table is proposed to include various shock scenarios that include 100 and 200 basis point shifts up and down in parallel, flattening, and steepening fashion as it relates to the yield curve. Bankers are performing interest rate risk sensitivity tests to manage interest rate risk. Therefore, from an investor’s perspective, we believe that stress test information can provide incremental value. However, we recommend that such information, as proposed, not be included

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<sup>13</sup> Additionally, it should be noted that banks – whether privately held or publicly held – with under \$300 million in total assets generally are exempt from reporting loans by maturity/repricing date for bank regulatory purposes. We believe those banks should not be required to provide this data.

as a required footnote disclosure. For publicly-held entities, we believe that more defined guidance from the SEC related to market risks can provide better comparability of the sensitivity testing that is already commonly presented within periodic filings. For privately-held banks, regulators and management have access to information that should be sufficient, rather than disclosure. Our conclusions about the interest rate sensitivity table are based on the following observations:

- The purpose of interest rate exposure measurement for regulatory purposes is to ensure sound practices for managing interest rate risk, within the context of a bank's point-in-time appetite for risk, ability to absorb risk, financial condition, and economic environment. In essence, interest rate simulations are part of a business risk control function and are not meant to measure or predict financial statement results. This objective is different from that of a financial statement user, who is interested in information to assess an entity's prospects for future net cash flows. An entity's prospects for future net cash flows will depend on realistic assumptions (for example, rates that gradually increase, as opposed to those that spontaneously increase), as well as its expected response to changes in rates (which would be present within a dynamic stress test). While we understand the value of interest rate stress testing for a bank investor, the proposed disclosure would necessitate a disclaimer by banks that the information in the tables is not meant to predict actual results.
- Banks currently perform these simulations primarily on net interest income and not on net income. We realize that reporting net income would capture the impact noted above on servicing assets and liabilities. However, there are bank services that are not necessarily considered interest rate sensitive (asset management services, for example) but would have an impact on net income given a change in interest rates. We do not believe such a broad-based analysis, with the accompanying complexities, will benefit users. Considering the narrow definition of "financial institution" in the ED (proposed language for ASC 825-10-50-23A), we interpret the objective of the proposed disclosure is to highlight interest rate sensitivity to net interest income. Therefore, expanding the scope to net income would be an unnecessary burden.
- Banks normally perform these tests on an economic value of equity basis and do not analyze how the results would be recorded in shareholder's equity (for example, amortized cost instruments would not be included in the analysis required in the ED)<sup>14</sup> Further, banks with trading portfolios that are monitored through VAR would be required to change the scope of their interest rate sensitivity simulations to include these portfolios. Complying with the ED would create new processes that, in the end, are less comprehensive when analyzing interest rate risk (thus, distorting the risk).

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<sup>14</sup> The May 17, 2012 Guidance related to stress testing (see footnote 7) specifically addresses capital stress testing. However, the stress tests are meant to address comprehensive impacts, based on interaction with other risks (such as credit risk) and other "knock-on" effects.

- The information in the proposed disclosure will often conflict with information within MD&A, which is presented using scenarios that management believes are most relevant. While current supervisory guidance by the U.S. banking regulators suggests rate shocks of 300 to 400 basis points, banks normally present basis point movements of 50 to 200, as they believe these are most relevant. Further, as noted above, management is likely to forecast gradual interest rate movement, which is generally the more likely outcome. A requirement to present only spontaneous shifts would needlessly require analysis and discussion on why the two scenarios provide different results.
- As much of the information in the proposed disclosure is not directly associated to financial statement line items, but to the entity as a whole, it is purely forward-looking information that should be excluded from the financial statements and limited to MD&A disclosure for public companies.
- The costs required to implement internal control systems and to have this information audited will be significant. As much of this information has not been part of financial reporting, requiring these proposed disclosures will be onerous and require the new use of specialists for many auditing firms. We also question whether auditing standards are robust enough in this area so that auditors and preparers understand what might be required -- and whether users will understand what they are getting under the audit umbrella.

To summarize our position on addressing interest rate risk, the repricing analysis table would only distort the interest rate risk to which most banking institutions are exposed – resulting in confusion rather than clarification for users. Further, if the table does not represent a bank’s interest rate risk exposure, we are concerned about what the bank’s responsibility might be to ensure that investors are not misled (such as disclaimers). We agree that interest rate sensitivity is relevant in helping financial statement users in understanding the extent of interest rate risk facing the entity. However, we do not believe that such information should be disclosed in the audited financial statements. The table does not support any numbers in the financial statements and is purely speculative, with no intention of providing accurate prospects on future cash flows to the organization. We recommend that the repricing table be eliminated and instead of requiring interest rate sensitivity testing as a disclosure within the financial statements, the FASB work with the SEC, the U.S. banking regulators, and industry to identify the best ways to reflect interest rate risks in MD&A and Call Reports, and base such disclosures on how management views those risks. As part of this review, we recommend that, due to the high costs of compliance and auditing, community banking institutions be exempt from these requirements.

## **Other Issues**

### **Scope**

The requirement in the ED to apply the standard based on whether an entity is a financial institution versus a non-financial institution, when combined with the need to focus on reportable segments, needs clarification. It is unclear how to assess reportable segments that have some but not all of the attributes of a financial institution. Many banks have reportable segments that

include broker/dealer and wealth management subsidiaries that, because of market making and client-directed activities, incur aspects of liquidity and interest rate risk. Based on the wording within the ED, these entities may not be considered financial institutions and, thus, non-financial institution schedules would be presented alongside bank schedules.

We believe that such non-financial institution-based disclosures that would be required by bank holding companies will confuse financial statement users and, therefore, we recommend application of the scope at the consolidated reporting entity level. If the entity is a financial institution, the financial institution disclosures would be provided for the consolidated company. If the entity does not meet the definition of a financial institution, it would next assess whether it has reportable segments that meet the financial institution definition and if so, provide the required disclosures at a segment level.

Thank you for your attention to these matters. Please feel free to contact me ([mgullette@aba.com](mailto:mgullette@aba.com); 202-663-4986) if you would like to discuss our views.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael L. Gullette". The signature is written in a cursive style with a large initial "M".

Michael L. Gullette