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November 13, 2008

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

Re: Other Than Temporary Impairment (OTTI)

Dear Chairman Herz:

In a letter addressed to you dated October 14, 2008, the Chief Accountant of the Securities and Exchange Commission (SEC), Conrad Hewitt, requested that the Financial Accounting Standards Board (FASB) “expeditiously address issues that have arisen in the application of the OTTI model in Statement 115.” The American Bankers Association (ABA) agrees that the “other than temporary impairment” model needs adjusting, and we urge the FASB to provide guidance expeditiously so that the guidance can be applied for December 31, 2008, financial reporting. ABA brings together banks of all sizes and charters into one association.<sup>1</sup>

Other than temporary impairment (OTTI) has been controversial for many years, especially subsequent to the implementation in 1994 of Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115). Recording OTTI that is based on credit impairment is non-controversial in the banking industry – financial institutions fully understand and support the need to record such impairment. However, there has been and continues to be much controversy over recording losses that are based on the market’s perception of value (fair value), which often results in recognizing losses that exceed credit losses or recording losses for instruments that have experienced no credit problems and are fully performing in accordance with their terms. The erosion of earnings and capital due to a market’s perception of losses or due to a lack of liquidity that drives values lower is misleading to investors and other users of financial statements.

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<sup>1</sup>ABA works to enhance the competitiveness of the nation’s banking industry and strengthen America’s economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry’s \$12.7 trillion in assets and employ over 2 million men and women.

The problems that exist in today's financial markets can be traced to many different factors. One key factor that is recognized as having exacerbated these problems is fair value accounting, which influences the recognition of OTTI. In today's illiquid market the results can be severe: (1) capital is artificially eroded despite solid fundamental credit performance, (2) the lending capability of a bank is reduced as much as \$13 for every \$1 of needless OTTI, and (3) the accounting formula is driving economic outcomes – including reduced availability of consumer and small business credit, with a negative impact on the health of individual institutions – and does not reflect economic reality.

Inasmuch as the current OTTI model is based on fair value estimates – from an often hypothetical market participant's perspective – with impairment recognized when the decline in fair value is considered other than temporary, it results in distortions, unnecessary complexity, and reduced transparency – and it suppresses economic activity. For example, the ABA met on September 25, 2008, with the SEC and other interested parties to discuss our concerns about how OTTI concepts were being applied, primarily for instruments that are fully performing.<sup>2</sup> Over the years there have been proposals and practices by accounting firms that utilized “bright lines” based on the severity and duration of declines in fair value. Those bright lines – or even not so bright lines – often result in permanent write-downs of fully performing assets or assets that subsequently recover value, but whose subsequent increases in value can only be recognized over the remaining life of the financial instrument, which can be many years. Additionally, the OTTI write-downs for non-credit related matters (without writing instruments up when liquidity improves) subsequently results in an artificially high yield ratio as the assets – debased in fair value estimates – continue to perform as originally contracted. In such a case, neither the write-down nor the resulting yield/income to maturity or sale is reflective of actual company “performance” or the result of operational decisions made by management. This results in volatility, particularly in today's markets, that is inaccurate for these instruments, is misleading to the users of financial statements, reduces transparency and comparability against peers, and introduces unwarranted uncertainty in the performance measurement of individual financial institutions. The resulting misleading information is contributing to the uncertainty in the markets and the freezing of investment.

There is and has been much confusion over what OTTI is and what it means. For example, is OTTI permanent? If not, is it closer to permanent than a pure fair value concept? If closer to permanent, then why are the short durations for recovery (such as 12 months) used by some of the accounting firms? If closer to pure fair value, should OTTI really result in impairment losses that cannot be reversed? What is the impact of an uncertain market on OTTI (that is, the lack of typical buyers and sellers, the definition of “exit price” in illiquid markets, the application of Emerging Issues Task Force Issue 99-20)? Should “bright lines” or other guidelines be used for severity, duration, or recovery? How should “market participants” be defined? How does one identify the assumptions a market participant would use when there are reduced numbers and types of market participants for an asset class? How is an illiquid transaction or market defined?

The intersection of two accounting concepts has introduced a negative bias into accounting for available for sale (AFS) securities. Those concepts are: (1) valuation of assets based on “exit price,” regardless of market conditions (SFAS 157); and (2) evaluation of assets for OTTI based on cash flow and other assumptions that a hypothetical “market participant” would use (Emerging Issues Task Force Issue 99-20). While these concepts may have been intended to enhance objectivity by forcing third party data to be considered, they have had the unintended consequence

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<sup>2</sup> See ABA's letter to the SEC dated September 11, 2008.

of creating accounting results that are often not based on reasonable assumptions and that are so negative that the results are truly not objective. Further, these concepts have driven companies and their auditors to spend huge amounts of time and money attempting to find or extrapolate third party support or market-based data for assumptions, when in fact such third party sources do not exist. Thus, the best estimate of fair value lacks the appropriate level of reliability that is needed for sound financial reporting purposes.

Preparers of financial statements and their auditors have continuously faced the following problems with the existing OTTI rules:

1. Determining whether or not an impairment loss must be recorded. Some auditors' views (along with the rules-based approach of the FASB's Emerging Issues Task Force Issue 99-20) suggest that a significant decline in fair value must be OTTI, even if there is no credit loss. In such a case, performing assets that have no credit losses are written down as impaired, with the result being a sort of "lower of cost or market" (LOCOM) approach reported in earnings.
2. Determining the amount of impairment to record. The loss recorded on impaired securities is the difference between book value and fair value. Thus, instruments that have any amount of credit loss – even small amounts – must be written down to fair value, sometimes necessitating larger write-downs than the credit loss entails.
3. Requiring that AFS securities not be sold. During the analysis of whether OTTI exists, it is sometimes determined that OTTI does not exist and that the reporting entity has the intent and ability to hold the instrument until a recovery of value. Unfortunately, this also has the contorted result of prohibiting sales of securities from AFS even though sound portfolio management strategies might suggest otherwise at a date preceding the estimated recovery.

After encountering these problems and recording instruments in accordance with the above, the resulting financial statements are misleading.

To help cure this situation, we recommend that the FASB adopt an OTTI model that is similar to that of the International Accounting Standards Board (IASB), but with some changes.<sup>3 4</sup>

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<sup>3</sup> Because the IASB's standard (IAS 39, *Financial Instruments: Recognition and Measurement*) is based largely on U.S. GAAP, there are also shortcomings with that model that also need to be overcome.

<sup>4</sup> Our understanding of the IAS 39 approach is that it focuses on loss events that provide objective evidence of impairment, and, if impaired:

- Held to maturity securities – the amount of impairment is determined by comparing the carrying amount of the instrument with the present value of future cash flows (excluding future credit losses that have not been incurred), discounted at the financial asset's original effective interest rate), essentially the credit impairment. If impairment loss subsequently decreases, the amount can be reversed through earnings.
- Equity securities carried at cost (unquoted equities or derivatives linked to unquoted equities) – the amount of impairment is determined by comparing the carrying amount and the present value of future cash flows discounted at the current market rate of return for a similar financial asset. If impairment loss subsequently decreases, the amount cannot be reversed.

The approach would be that for Held to Maturity (HTM) and AFS OTTI recognition in earnings:

- OTTI would exist if loss events provide objective evidence of credit impairment.<sup>5</sup>
- The amount of impairment would be determined by comparing the carrying amount of the instrument with the present value of estimated future cash flows (excluding future credit losses that have not been incurred), discounted at the financial asset's original effective interest rate.
- If impairment loss subsequently decreases, that amount would be reversed through earnings.

Under our recommended approach, HTM and AFS would continue to be reported as described in the current accounting literature (SFAS 115), with HTM reported at amortized cost and AFS at fair value (with changes in fair value reported in other comprehensive income) and with the existing robust disclosures. Under this model, just as in a fair value model, the need for rigorous, objective analysis must also involve reasoned judgment.<sup>6</sup>

We note that this approach may be difficult to apply for some smaller institutions and may be difficult to apply for all banks for all instruments by December 31, 2008 (due to the need for systems changes, etc.). However, it is very important that the new model be available. Thus, entities should be given the option of following the current U.S. accounting rules for OTTI or the new model for OTTI and should have the option of applying the new model to individual instruments. We believe there are precedents for this (Statement of Financial Accounting Standards No. 159, *Fair Value Option*), and it would result in improved information for users of financial statements.

Basing OTTI on credit risk would result in more logical financial statements. For example, under SFAS 115, a financial institution must identify instruments that are "available for sale". However, under current practice relating to OTTI, the financial institution is also required to ascertain that it has the intent and ability to hold the instrument until recovery if OTTI is not recorded. Thus, the same instrument that is labeled as "available for sale" is also labeled with the "intent to hold", which are contradictory. This is extremely illogical to financial institution preparers and cannot possibly be logical to investors and other users of financial statements. This new model for OTTI would help remedy that situation.

The U.S. GAAP model for OTTI simply has not worked well and has not served investors well. We strongly encourage the FASB to issue a proposal quickly that would utilize credit risk

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- Available for sale – the amount of impairment is the cumulative loss that has been recognized in other comprehensive income, and is reclassified from equity to earnings. The amount that is reclassified is the difference between amortized cost and fair value, less any impairment loss previously recognized in earnings. If impairment loss subsequently decreases: (1) for equity securities, the amount cannot be reversed through earnings, (2) for debt securities, the amount can be reversed through earnings.

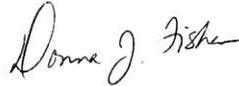
<sup>5</sup> We anticipate that for most classes of securities that most banks are permitted to own there should not be a need for extensive documentation to support the lack of recognition of OTTI.

<sup>6</sup> The purpose of this letter is to address OTTI and not whether other parts of SFAS 115 may need to be amended. Thus, this letter assumes that SFAS 115 continues to be the basis for investment securities.

rather than fair value to determine OTTI. Fair value fluctuations – as demonstrated in today’s market – generally do not provide either a true fair value or economic value. Our recommendation would result in simplification and more meaningful information for users of financial statements. Our hope is that this new approach can be applied for December 31, 2008, financial reporting purposes.

Thank you for considering our views. We would be pleased to work with you on this project.

Sincerely,

A handwritten signature in cursive script that reads "Donna J. Fisher".

Donna Fisher

cc: Conrad Hewitt, Securities and Exchange Commission  
Jim Kroeker, Securities and Exchange Commission  
Charles Holm, Federal Reserve Board  
Arthur Lindo, Federal Reserve Board  
Jeffrey Geer, Office of Thrift Supervision  
Zane Blackburn, Office of the Comptroller of the Currency  
Robert Storch, Federal Deposit Insurance Corporation