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LETTER OF COMMENT NO. 31A

Mr. Russell Golden Technical Director Financial Accounting Standards Board 301 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Via email: director@fasb.org

File Reference: Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b, Recognition and Presentation of Other-Than-Temporary Impairments

Dear Mr. Golden:

The American Bankers Association (ABA)¹ appreciates the opportunity to comment on the Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b, Recognition and Presentation of Other-Than-Temporary Impairments ("proposed FSP"). Certain aspects of current accounting guidance and practices are resulting in financial statements for banks that are not transparent and are misleading to users of financial statements. ABA unequivocally supports transparency in financial reporting, both as preparers of financial statements and users of others' financial statements. Therefore, we believe it is critical to make immediate improvements to financial reporting – in this case, improvements to fair value accounting and Other Than Temporary Impairment (OTTI). We commend the staff's efforts to better address these key issues.

The ABA strongly supports the proposal and recommends its immediate approval. Specifically, we believe that the threshold to recognize credit losses through earnings — when management does not have the intent or the requirement to sell the security — is certainly more operational and provides a truer economic picture than the current guidance.

Although the ABA supports the proposal, we strongly encourage the FASB to take this opportunity to repair the problems with OTTI as fully as possible. We understand that there are concurrent FASB/IASB efforts to examine some of these issues, and we encourage the FASB to accelerate efforts to rectify these issues.

<sup>&</sup>lt;sup>1</sup> ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$12.7 trillion in assets and employ over 2 million men and women.

Below, we have recommendations for this specific proposal as well as longer-term solutions. We believe the following recommendations will materially improve transparency, reliability, and clarity:

Recommendations for the proposed FSP:

- The final FSP should apply to securities with OTTI at the effective date. The FSP should include a "true-up" for securities with OTTI by recording a one-time beginning balance cumulative adjustment between retained earnings and other comprehensive income. This will help avoid confusion and will increase consistency and comparability in the accounting for securities. It is also consistent with the approach taken for many other new accounting standards.
- The effective date should be second quarter 2009, with earlier adoption permitted. Although we believe strongly that the proposed FSP should be effective for first quarter 2009, we also know that some entities will not be able to do the work needed in time to prepare their financial statements. Providing a second quarter effective date with earlier adoption permitted will help those whose systems and analyses require additional time.
- OTTI for HTM securities should be based on credit losses rather than mark to market losses. We agree that probable credit losses represent actual economic losses of a security and should be recorded in earnings. However, non-credit losses on HTM debt securities should not be a part of OTTI at all. Recording non-credit losses in other comprehensive income for an HTM debt security, only to accrete that loss back to the security, will confuse users both at the time of the impairment as well as over the holding period.
- Further guidance is needed on "intent to sell" an impaired security (and "more likely than not that it will not sell the debt security prior to recovery"). More guidance will be needed to avoid confusion that has arisen from the current practice over the past several years, especially related to "tainting".
- Clarification is needed on the meaning of "credit losses". The final FSP should clarify that the amount of OTTI to be recognized through earnings is credit loss rather than "credit risk".

Longer-term recommendations:

Recoveries of OTTI should be reversed. OTTI should not be permanent
if, in fact, the impairment is not permanent. Recoveries of OTTI should be
immediately reversed through earnings in order to more accurately reflect

performance of the borrower of the underlying assets and to provide consistency with other impairment accounting.

• More guidance on application to equity securities is needed. There are specific circumstances in which we believe "credit losses" should be applied to equity securities.

#### Background Relating to OTTI

As acknowledged at the March 16, 2009 FASB board meeting, the OTTI rules and practices accompanying those rules have been problematic for many years. Although there are many reasons for the problems, the best example is debt securities. In contrast to common stocks, debt securities, absent credit problems, have cash flows that are contractual and certain. In many cases, however, when losses are neither probable nor reasonably estimable, banks and other long-term investors have been required to mark to market (MTM) those debt securities and record losses – even when they do not intend to sell. These MTM losses on fully performing securities are often recorded permanently in earnings as OTTI. In other words, banking institutions must record, permanently in earnings, the market's view of losses, which often has no relationship to losses that are expected to occur. Further, those losses cannot be reversed through earnings<sup>2</sup>, even if the market changes its views about the values or the losses do not materialize. This example helps demonstrate how, in the current market environment, banking institutions and others are being required to materially overstate economic losses.

This should not be interpreted that we oppose MTM. The following help clarify ABA's position:

• MTM is important when an entity's business model and cash flows are based on MTM (such as trading and, as in the proposed FSP, when there is the intent or expectation to sell). MTM information, which is included in the footnotes to financial statements, can also be useful to more sophisticated investors or other users of financial statements. MTM should not be used for OTTI, however, unless an entity has the intent or expectation to sell.

For traditional banks, including MTM within OTTI violates two of the objectives detailed in Statement of Financial Accounting Concepts No. 1: Objectives of Financial Reporting by Business Enterprises.

- o Information is useful is assessing cash flow prospects
- Management stewardship and performance

Traditional banking is not based on buying and selling in the markets; instead, it is based on net interest margins and fee income. Thus, mark to

<sup>2</sup> It is understood that recognized OTTI losses are amortized over time as an adjustment to the security's yield. In addition to the problems discussed, this treatment greatly distorts the analysis of net interest margins.

market results in misleading volatility that does not reflect the cash flow business model of banking, and management performance is greatly distorted because banks manage cash flows and credit risk, not short or intermediate term fair values.

- MTM should not be suspended. As mentioned above, MTM can be very useful. However, the method to determine MTM should be improved, which is the topic of another proposed FSP.
- Banks agree with reporting credit losses. This provides users of financial statements with information that is important in evaluating the quality of assets. However, losses for OTTI should be based on credit impairment as is the case for loan losses.

## Recommendations for the proposed FSP

#### The final FSP should apply to securities with OTTI at the effective date.

We agree with the proposal to provide better information to reflect probable credit losses by bifurcating market-related losses from credit losses. However, the proposal to prospectively apply this guidance will result in inconsistencies and non-comparability, because the amounts recorded for OTTI will be mixed. Both preparers and users of the financial statements will be faced with reconciling and analyzing how much OTTI results from credit losses recorded subsequent to the time full fair value losses were recorded (prior to 2009), as well as full fair value losses on those impaired securities that the bank intends to sell or it is more likely than not required to sell prior to recovery. Effective analysis of net interest margins, as well as market performance, will be difficult.

In order to avoid such confusion, we recommend that a one-time beginning balance adjustment be allowed as of January 1, 2009. A similar beginning balance adjustment was, in effect, allowed in applying the Fair Value Option (SFAS 159), and it is appropriate at this time. The entity will then report the effect of the first reclassification of market-related OTTI as a cumulative-effect adjustment to the opening balances of retained earnings and accumulated other comprehensive income.

# The effective date should be second quarter 2009, with earlier adoption permitted.

While we believe that the proposal should become effective as soon as possible, we understand that there are certain institutions that will find implementation to be nearly impossible for the first quarter. Smaller institutions that lack sophisticated cash flow modeling tools will be executing these kinds of analysis for the first time. Further, larger organizations with vast portfolios that have not been required to

analyze credit losses in this manner may also be similarly challenged. With this in mind, we recommend that the effective date of the proposal be changed to periods ending after June 15, 2009, with earlier adoption permitted.

## OTTI for HTM securities should be based on credit losses rather than MTM losses.

The proposal to include market-related OTTI for HTM securities in OCI confuses users of the financial statements because HTM securities are to be held to maturity. Recording market-related OTTI contradicts the very principle that HTM securities are sheltered from market price influence. Recording non-credit losses in other comprehensive income for an HTM debt security, only to accrete that loss back to the security over time, is illogical and confusing.

With this in mind, we recommend that OTTI for HTM securities be limited only to credit losses, which is similar to the accounting used in international accounting standards.

#### Further guidance is needed on "intent to sell" an impaired security.

ABA firmly agrees with the proposal that credit losses (as opposed to MTM losses) should be recorded through earnings (if the company is not planning to sell the security or it is more likely than not that the company will not sell it prior to recovery). This will improve transparency for the financial statement user, and it much more accurately presents true economic losses that have been incurred. This is a positive step that helps address the underlying differences between debt securities and equity securities, and one that has been problematic for many years.

With that in mind, however, we believe more guidance is needed to avoid confusion that has arisen from the practice over many years relating to "tainting" the portfolio if a security is sold. Auditing management's "intent" and "likelihood of sale" will bring up numerous questions as to timing, analysis, and documentation that may prove to be overly burdensome to many organizations. We believe it is not FASB's intent to create such an environment, and we do not advocate "bright lines". However, further guidance is required to avoid such a situation.

#### Clarification is needed on the meaning of "credit losses".

We recommend that the meaning of "credit losses" be expanded in the final FSP. We support the use of a cash flow methodology similar to that described in SFAS 114. However, we believe that to avoid misapplication of discount rates, the FSP should note that it is not the "credit risk" (as measured under SFAS 159, Fair Value Option), but the actual credit loss that is to be recorded. Further, the discussion should address other issues, including whether incurred, yet unidentified, impairment should be part of the calculation, as is performed in accordance with SFAS 5.

## Longer-term recommendations

#### Recoveries of OTTI should be reversed.

When OTTI is determined to have recovered, the recovered portion should be immediately reversed. Immediate reversal of OTTI furthers convergence with current International Financial Reporting Standards. Additionally, immediate reversal of OTTI will maintain consistency with recoveries of losses on impaired loans as calculated in SFAS 114. Excluding recoveries from retained earnings reduces transparency as to the performance of the underlying assets (or the market) and recording them will also allow better net interest margin analysis, as appropriate book values will be up-to-date.

#### More guidance on application to equity securities is needed.

As noted above, equity securities are different from debt securities. Common stocks have no contractual cash flow and the market value of equity securities often directly affects the company's ability to raise capital to fund growth (which would provide for cash flow). With that said, we believe there are circumstances in which the separation of credit losses should apply to equity securities.

For example, there are currently mutual funds (registered investment companies formed under the Investment Act of 1940) that invest solely in debt securities (mortgage securities), that are closed to new investors, and have implemented an "inkind" redemption policy (shareholder redemption is satisfied through the distribution of a proportionate share of each security in the fund). FSP FAS 115-1 disallows the "look-through" process to the underlying assets of mutual funds because of the lack of control over the individual investments. In this circumstance, however, where total control of the underlying investments is retained, the identification and separation of credit losses from market losses is appropriate for this equity security. We, therefore, also believe the guidance on intent or requirement to sell the security would be appropriate for these kinds of equity securities. This guidance would also be applied up to the time that such securities are opened to new investors or standard redemption policies are resumed.

Another example of an equity security that may be considered to have a credit loss component is a perpetual preferred security. However, there will necessarily be other specific examples as these products evolve. More guidance on how to evaluate losses on these securities is suggested.

#### Summary

To summarize, ABA strongly supports this proposal as well as longer-term efforts to address the many problems with OTTI. We encourage the FASB to address all of our recommendations, including the longer-term recommendations, if at all possible.

We recognize that your turnaround time is short, and we believe the focus should be on finalizing the FSP so that it can be available to be implemented for the first quarter, 2009.

Thank you for your attention to these matters and for considering our views. Please feel free to contact Mike Gullette, ABA's VP of Accounting and Financial Management (mgullette@aba.com; 202-663-4986) or me if you would like to discuss our views.

Sincerely,

Donna Fisher

Donne J Fisher