

1-800-BANKERS www.aba.com



Wintd-Class Solutions, Leadership & Advocacy Since 1875

**Donna J. Fisher** SVP - Tax and Accounting

Phone: 202-663-5318 Faxo 202-663-5209 Emul: dfisher(q aba.com



December 28, 2008

LETTER OF COMMENT NO. /5

Technical Director
Pinancial Accounting Standards Board
301 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: Proposed FSP EITF 99-20-a (Amendments to the Impairment and Interest Income Measurement Guidance of EITF Issue No. 99-20)

## Dear Technical Director:

The American Bankers Association<sup>1</sup> (ABA) appreciates and supports the efforts of the Financial Accounting Standards Board (FASB) to address the application problems relating to current accounting guidance included in Emerging Issues Task Force Issue No. 99-20 for "other than temporary impairment" (OTTI). ABA agrees that recording impairment provides users of financial statements with meaningful information. However, particularly in this environment – post-Sarbanes Oxley Act and in combination with a dysfunctional market – the application of OTTI guidance, along with the new definition of fair value, are resulting in an overstatement of impairment. It is critical that new OTTI guidance be issued, applied properly and with reasoned judgment, and applicable for December 31, 2008 reporting.

## FSP EITF 99-20-a

We strongly support the Proposed FASB FSP EITF 99-20-a, Amendments to the Impairment and Interest Income Measurement Guidance of EITF Issue No. 99-20 (the proposal), which would amend EITF Issue No. 99-20 (Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets). We agree that it will achieve more consistent determination of whether OTTI of available-for-sale (AFS) or held-to-maturity (HTM) debt securities has occurred. We believe it is imperative that this proposal be finalized and applicable for December 31, 2008 reporting.

The FSP requested information about whether the SFAS 115 impairment model is operational for beneficial interests that were previously within the scope of Issue 99-

The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$13.6 trillion in assets and employ over 2 million men and women.

20. It should be noted that as part of the service provided to community banks, sellers of certain types of securities provide estimated cash flows to the buyers of the securities upon request. During the audit process, some auditors have required that a third party provide the cash flows (as the community banks may not have the resources to estimate the cash flows internally). This is becoming extremely costly for community banks, which needs to be considered as we move forward with improvements to both the accounting for and auditing of financial instruments. However, based on input received to date from ABA members, it is our understanding that many community banks are already being required by their auditors to perform these cash flows.

On a related matter, it is also our understanding that some accounting firms have their own models for estimating these cash flows. In some circumstances, the firms are requiring that the firms' estimated fair values be used by their clients, but do not provide clients with the assumptions used nor the actual cash flows. We believe this practice goes against the intent of the Sarbanes-Oxley Act, by requiring companies to use cash flows without the appropriate documentation or understanding of the estimates. This is clearly an auditing issue, but one that we believe is appropriate to raise in the context of OTTI accounting.

## Additional Steps Needed

Although the proposal addresses certain problems with EITF 99-20, it resolves only a portion of the problems with the accounting for OTTI. We request that the FASB take additional steps so that December 31, 2008 financial reporting will provide more meaningful information to users of financial statements.

We read, with much interest, the comment letter written to the FASB on December 23, 2008, by former FASB Chairman Dennis R. Beresford who is currently the Ernst & Young Executive Professor of Accounting at The University of Georgia. His letter included the following, with which we agree:

"...the proposal fails to deal with the much larger and important issue of how other than temporary impairment (OTTI) is being applied in practice to debt securities...I urge you to use the very limited window of opportunity in the next few weeks to deal with OTTI more broadly."

The Securities and Exchange Commission (SEC) has acknowledged that problems exist with U.S. Generally Accepted Accounting Principles (GAAP) for OTTI. The SEC wrote to the FASB on October 14, 2008, requesting that the problems with OTTI be "expeditiously" addressed. Somewhat similarly, the International Accounting Standards Board (IASB) has acknowledged the problems with U.S. GAAP, as the IASB's accounting model for investment securities is based on U.S. GAAP, but with improvements relating to OTTI. The differences between the IASB's model and U.S. GAAP are likely to reflect materially different results for U.S.

companies versus their foreign competitors in the area of OTTI for 2008 reporting.<sup>2</sup> The additional steps we are recommending bring U.S. GAAP closer to that of the IASB.

The current OTTI rules are misleading, and have been problematic for many years. Generally Accepted Accounting Principles (GAAP) that apply to the recognition and measurement of impairment losses are different for loans versus debt, even though the underlying cash flows for both asset types might be exactly the same. Similarly, it does not appear to be permissible to look through to the cash flows of underlying securities for certain types of mutual funds, even though those securities provide the cash flows to support the investments. These problems have been exacerbated by current illiquid markets where there the market values or fair values in nonfunctioning markets are inappropriate for measuring impairment losses. In some cases, there is limited to zero trading in certain classes of securities. Even though the markets are not functioning normally, our members are still required to base their accounting on "exit" prices, information based on market participants' views, indicative prices, and screen prices that can not be transacted upon. We believe that utilizing dysfunctional market prices to record OTTI in the income statement, as opposed to "other comprehensive income" (OCI) is very misleading to investors. It is also illogical that recording OTTI results in permanently recognizing losses in income without the ability to reverse those losses if the amount of OTTI recognized improves (which is not the case with OCI).

In some cases, large losses are being required to be reported, even though there is a minimal amount of credit loss related to an investment. Again, we refer to the letter of former FASB Chairman Beresford:

"The SEC and EITF have each issued documents that provide factors that should be considered but the final determination of whether a security is other than temporarily impaired often remains a judgment call by companies and their auditors. In today's somewhat dysfunctional markets for debt securities, auditors are naturally cautious about how OTTI should be applied and probably lean toward impairment write downs when there is a close call. I am aware of one situation where a company's projections of future cash flows from mortgage backed securities fell well less than 1% short of full collection of principal and interest based on models that showed questions about full collection of underlying mortgage loans many years in the future. In this case, the accounting firm insisted that OTTI had occurred and required a write down through earnings of over 40% of the carrying amount of the security based on very limited market information. Recognizing what

<sup>&</sup>lt;sup>2</sup> The views in this letter do not represent the entirety of our concerns with the accounting for financial instruments; instead, the letter focuses on issues that need to be addressed for December 31, 2008 financial reporting.

seems to be a major liquidity discount in current income doesn't seem to represent a true measure of the event that triggered the OTTI."

We are in agreement with Chairman Beresford's example of overstating losses, and it is one that many of ABA's members are experiencing.

We have been surprised with the level of discussion from some accounting firms and others that fair value is not a significant issue for most banks, because banks do not have a significant volume of financial instruments that are subject to fair value through earnings. This does not take into consideration the broad impact that fair value is having on financial statements, as all financial instruments are subject to OTTI, publicly reported equity includes unrealized gains and losses for AFS that are not reported in earnings, and the pro-cyclical impact of fair value is being felt in the markets by many different types of industries, including financial services. Similarly surprising to us is the recommendation by some that the banking agencies change their capital rules relating to OTTI rather than change U.S. GAAP. We believe it is very important that the accounting be repaired for public reporting purposes under U.S. GAAP for December 31, 2008 financial statements. If the banking agencies believe that further repairs are need for regulatory reporting purposes, it would be entirely appropriate for them to do so. However, we first need to ensure that public reporting more closely reflects financial performance.

It seems to us that there needs to be a meeting of the minds on OTTI by all parties – preparers, auditors, and regulators. Reasoned judgment is needed in order to ensure that financial reporting results in the appropriate level of losses and does not significantly overstate impairment. For example, if it is probable that all amounts will not be received, then the amount of impairment should be based on that estimate. We believe the model used by the IASB, which is based on credit impairment rather than fair value, represents a superior approach to U.S. GAAP. Our recommendations are as follows:

- Revise the loss recognition model for impaired debt securities by recognizing currently in income only those impairments representing probable loss of contractual cash flow. Thus, the trigger for OTTI would be based on credit impairment, similar to that of the IASB, rather than fair value.
- For AFS securities, continue to recognize the difference between the amount of impairment recognized and the decline in a security's fair value in OCI.
- Reverse any recoveries of OTTI through earnings.
- Permit the effective date for recent transfers to HTM or AFS to be the same effective date used by the IASB.
- Clarify that liquidity risk referred to in FSP 157-3 is not based on distressed sales.<sup>3</sup>

<sup>&</sup>lt;sup>3</sup> The application of FSP FAS 157-3, in practice, appears to be circular. It requires inclusion of the liquidity risk that a market participant would use in estimating fair value; however, it also acknowledges the need for the use of significant judgment and does not require reliance on distressed sale prices for estimating fair value. In this market, the inclusion of liquidity

We appreciate the FASB's recent decision to work with the IASB on a joint project relating to these matters. Although we believe the IASB's model for OTTI is superior to that in U.S. GAAP, improvements to their model are needed (that is, measuring AFS impairment losses based on credit impairment rather than on market value impairment). If this is not possible to complete for 2008 reporting, we recommend that U.S. GAAP be brought up to at least the IASB's standards for OTTI for December 31, 2008 financial reporting.

We are eager to continue to work with the FASB on this effort. Please feel free to contact me to further discuss these issues. Thank you for considering our views.

Sincerely,

Donna J. Fisher

Donne J Fisher

cc: Mark Olson, Chairman, Public Company Accounting Oversight Board