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Financial Accounting Standards Board
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RE: File Ref. Nos. 2013-220 & 2013-221
Financial Instruments – Overall

File Ref. No. 2012-260
Financial Instruments – Credit Losses

Members of the Board & Trustees of the Foundation:

On behalf of Sandler O'Neill + Partners, L.P., I am commenting on the Board's Exposure Drafts ("EDs"), *Financial Instruments–Overall* and *Financial Instruments–Credit Losses*, the first issued in two installments on February 14 & April 12, 2013 for comment by May 15, 2013, and the second on December 20, 2012 for comment by May 31, 2013. Together, the EDs propose new models for the classification and measurement of financial instruments ("CMED") and for the recognition of credit losses on debt instruments ("CLED"). The FASB staff subsequently supplemented the CLED with *Frequently Asked Questions* ("FAQ"), issued March 25, 2013, which clarifies the CMED as well as the CLED.¹

Although we describe and discuss key features of these proposals in this letter, we do so primarily as a means of providing a broader conceptual critique of the Board's stewardship of generally accepted accounting principles in the United States ("U.S. GAAP"), which we regard as deficient by reason of its inconsistency with the Board's own due process. In the absence of a return to first principles, in which the Foundation needs to assist the Board, we believe that investors will be ill served in the financial instruments project and could be better served in the credit losses project.

We stress that nowhere in this letter do we intend to impugn the Board's good faith, for we have nothing but respect for the Board and its challenging, important work. Rather, we believe the Board is too close to the problems discussed to see them clearly or

¹ The Board describes the second part of the classification and measurement exposure draft as a "companion document" to the first implementing various "consequential amendments," including the elimination of the fair value option for financial instruments not within the scope of the CMED. The companion document is subtitled "Proposed Amendments to the *FASB Accounting Standards Codification*." We refer to it herein as "CMED-CD."

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accurately assess their magnitude and consequences, which we hope this letter will help the Board to do. Not to speak frankly but respectfully at this juncture would be a disservice to the Board and Foundation, as well as to investors and preparers who are our clients.

Sandler O'Neill is a market-leading, full-service investment banking firm and broker-dealer focused on the financial services sector.² We address the Board and the Foundation as a firm of financial professionals who work closely with a wide variety of financial companies. Our clients include some one thousand such companies, including banks and thrifts, insurers, and their holding companies, as well as investors in them.

Overview of Key Provisions

The EDs are two parts of the broader financial instruments project that the FASB and the International Accounting Standards Board ("IASB") are jointly deliberating.³

Classification & Measurement

The CMED would classify financial instruments into one of three measurement categories: amortized cost ("AC"), fair value with changes in value recognized in other comprehensive income ("FV/OCI"), and fair value with changes recognized in net income ("FV/NI").

These categories correspond closely to the held-to-maturity, available-for-sale, and trading classification of securities under current U.S. GAAP.⁴ However, there are two significant differences: (i) for financial assets the contractual cash flow characteristics of the instrument would supplant business strategy as the primary classification gatekeeper,⁵ and (ii) the measurement categories would apply to loans as well as

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³ On March 7, 2013 the IASB published its Exposure Draft, *Financial Instruments: Expected Credit Losses*, on which comments are due July 5, 2013. The IASB had previously published its classification and measurement proposal, Exposure Draft, *Classification and Measurement: Limited Amendments to IFRS 9* (November 2012), whose comment period ended March 28, 2013.

⁴ See CMED, ¶¶ 825-10-55-28 to 825-10-55-39.

⁵ As we discuss below, the proposed ascendancy of contractual cash flow characteristics as the primary arbiter of classification and measurement reflects a long-standing animus toward "accounting based on intent" dating back to Statement of Financial Accounting Standards ("SFAS") No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (May 1993). See SFAS 115 at ¶ 27.

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securities. Notwithstanding the inclusion of loans within the scope of the proposal, it would continue the prohibition of hedging the interest rate risk of debt securities measured at AC but would permit such hedging for loans measured at AC.⁶

To be eligible for AC or FV/OCI classification the contractual terms of a financial asset would have to give rise to cash flows on specified dates consisting solely of payments of outstanding principal and interest on that principal. Such instruments held for the single objective of collecting contractual cash flows would be measured at AC, whereas those held for the dual objective of collecting cash flows and realizing changes in fair value through sale would be measured at FV/OCI. FV/NI would be the default category for financial assets not measured at AC or FV/OCI.⁷

The consequences of the cash-flow and business-model criteria are that the only financial assets eligible for AC or FV/OCI classification would be plain-vanilla loans and debt securities.⁸ All other assets would be classified FV/NI, including (i) tranches of securitized financial assets having greater exposure to credit risk than the underlying pool, and (ii) equity investments other than those subject to the equity method of accounting and not held for sale.

Financial liabilities generally would be measured at AC unless they are held with the objective to transact subsequently at fair value or they result from a short sale, in which case they would be measured at FV/NI. Insurance-contract liabilities would be an exception to the general rule and would be measured at FV/OCI pursuant to ongoing deliberations in the boards' joint insurance contracts project.⁹ The fair value option for changes in the fair value of financial liabilities due to changes in the issuer's own credit risk would be measured at FV/OCI.

Credit Losses

The CLED would apply to all financial assets subject to credit losses and not measured at FV/NI, including debt securities, loans and loan commitments, lease and trade receivables, and reinsurance recoverables.

⁶ The contradictory treatment extends to both fair-value and cash-flow hedging. See CMED-CD, ¶¶ 815-20-25-43 (c)(2) & (d)(2), at p. 142.

⁷ We note that under current U.S. GAAP the available-for-sale, or AFS, category is the default classification. See SFAS 115, ¶ 12(b).

⁸ Hybrid financial assets would not be bifurcated between the host contract and embedded derivatives but would be classified in toto in one of the three categories. However, bifurcation requirements for derivatives embedded in hybrid financial liabilities would be retained.

⁹ See CMED, ¶¶ 825-10-15-8 & BC25.

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The CLED proposes the recognition of a credit impairment allowance in an amount reflecting the current estimate of future contractual cash flows not expected to be collected. There would be no requirement of probability of loss, and the allowance would reflect all expected losses based on all relevant information, including reasonable and supportable forecasts of the future. At each reporting date the balance sheet would reflect the current estimate of expected credit losses, and the income statement would reflect in net income any changes in the allowance (positive or negative) during the period.¹⁰

Interest income generally would be recognized on the basis of contractual cash flows. However, for purchased financial assets that have experienced significant credit deterioration since origination, the corresponding discount embedded in the purchase price (nonaccretable yield) would never be included in interest income. Except for this difference, originated and purchased credit impaired financial assets would be accounted for similarly.

Frequently Asked Questions

The FAQ addresses numerous issues relevant to the CLED, but its most interesting contribution to understanding both the CLED and CMED is to explain the Board's view that the objective of measurement at amortized cost is "to reflect the present value of cash flows that an entity expects to collect" (Q&A 1). The CMED and CLED achieve that objective through the combination of the "measurement of the amortized cost basis of the financial asset at a present value, based on *contractual cash flows* and . . . an allowance for credit losses at a present value, based on *contractual cash flows not expected to be collected*, both discounted at the effective interest rate [emphasis in original]."

Discussion

The CMED and CLED develop the Board's previous proposals for classifying and measuring financial instruments and recognizing credit losses. Its May 26, 2010 proposal would have applied a full fair value model to most financial instruments, requiring changes in fair value to be recognized in net income. Under a limited exception, changes in the fair value of certain debt instruments could have been recognized in OCI by an entity whose business strategy was to collect or pay their contractual cash flows for a significant portion of their term.

¹⁰ A financial asset measured at FV/OCI would be exempt if its fair value exceeds its amortized cost basis and expected credit losses on the asset are not significant.

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The Board also proposed a single approach to assessing credit impairment of all financial assets in the May 2010 proposal, which its January 31, 2011 supplementary document superseded. That document discussed three models for recognizing expected credit losses on loans and debt instruments: a separate IASB model with an income-statement focus matching the recognition of interest income and credit expense; a separate FASB model with a balance-sheet focus immediately recognizing all credit losses expected to occur in the foreseeable future; and a joint model combining elements of each.¹¹

Like their predecessor proposals, both the CMED and CLED are symptomatic of a longstanding disregard of due process coincident with the mutation of accounting standard setting into shadow supervision. That the CLED is less symptomatic arises from the fact that the Board is better able to acknowledge and respond to what investors want when it is not blinded by fair value orthodoxy.¹² Fair value orthodoxy is one of two codependent agents of shadow supervision. The other is a commitment to universal audit reflected in the progressive relocation of disclosures in financial reports from MD&A to the notes and from the notes to the face of the financial statements.¹³

In brief, *fair value orthodoxy* is the faith-based belief that fair value is the accounting cure-all for otherwise deficient financial information, and *universal audit* is the companion belief that no information – financial or not, factual or not – should be beyond the reach of audit. Together, fair value orthodoxy and universal audit are the twin engines of shadow supervision that the Board is promulgating through setting accounting standards and disclosure requirements and enforcing through audit.¹⁴ *Shadow supervision* itself is

¹¹ Sandler O'Neill commented on both documents in letters dated August 31, 2010 and March 28, 2011, opposing the adoption of the classification and measurement proposal and recommending the issuance of an exposure draft proposing the Board's separate approach to revising impairment guidance, urging the Board to remain open to the possibility that the incurred-loss approach to impairment was not as broken as advocates of an expected-loss approach asserted.

¹² We document and discuss the rise of fair value orthodoxy in our September 6, 2012 Basel III comment letter to the federal banking agencies opposing their proposed inclusion of unrealized gains and losses on available-for-sale securities in the regulatory capital of U.S. banks. That letter is available at http://www.federalreserve.gov/SECRS/2012/September/20120917/R-1442/R-1442_090612_108296_324562014337_1.pdf.

¹³ See the Board's recent Discussion Paper, *Disclosure Framework* (July 12, 2012), on which Sandler O'Neill commented in a letter dated November 28, 2012. That letter is available at <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175825209114&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs>.

¹⁴ To guard further against gaming financial reporting, the Board also sometimes resorts to reductive thinking in formulating accounting conventions. For example, the central conceit of the leasing project is that because some leases clearly are financed purchases, all leases should be accounted for as such, which would have the effect of including all lease liabilities on the balance

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the use of accounting conventions, disclosures, and audit to impose the Board's vision of risk management on reporting entities rather than to provide investors with information helpful to them in reaching investment conclusions.

Due Process Context

The due process to which the Board has committed itself in setting accounting standards has two dimensions: substantive and procedural. Of the two, substantive due process – *what* the Board should be doing – is the more important because procedural safeguards derive from it, and without the Board's unwavering, self-aware commitment to substantive due process, procedural due process – *how* the Board conducts its business – will be for naught, as it too often has been for 20 years.¹⁵

In September 2010 the Board converged with the IASB upon the most fundamental tenet of substantive due process:

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.¹⁶

Excluded from this cohort of *primary users* are regulators because they can “require reporting entities to provide information directly to them.”¹⁷ The Board's articulated commitment to serving the needs of investors, lenders, and other creditors (together,

sheet. Such reductive thinking has less to do with accounting that accurately reflects business models and the substance of transactions than with shadow supervision. See the Board's Exposure Draft, *Leases* (August 17, 2010).

¹⁵ Procedural due process consists of elements such as the publication of proposals for public comment, other forms of outreach such as roundtables, and public Board meetings. Procedural due process is robust, and the Board is justifiably proud of it.

¹⁶ FASB, Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting* (September 2010), ¶ OB2; IASB, *Conceptual Framework for Financial Reporting: Project Summary and Feedback Statement* (September 2010), p. 4. We discuss the importance of due process and incrementalism to accounting convergence in our July 29, 2011 letter to the SEC's Chief Accountant, available at <http://www.sec.gov/comments/4-600/4600-69.pdf>.

¹⁷ FASB, Concepts 8, ¶ BC1.9. The only role Concepts 8 assigns academics (along with preparers, users, and auditors) in the development of accounting standards is consultation on the cost-benefit analysis of a proposed standard (¶ QC38).

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“investors”) in its work is longstanding, dating back to the creation of the Board or very close to it.¹⁸

The Board continues by clearly distinguishing between the information contained in financial reports and the use investors are expected to make of it:

General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders, and other creditors to estimate the value of the reporting entity.”¹⁹

What is key here is that general purpose financial reports – and financial statements in particular – are to provide “information” rather than “estimates”: in other words, factual financial data rather than speculation, on the basis of which investors are to form their own “estimates” of value as they see fit. The fact that much fair value accounting is inconsistent with this core tenet comes sharply into focus with financial institutions, and banks especially given the propensity of the Board to regard them as mutual funds whose defining metric is net asset value.²⁰

Investors: Neglected “Primary” Users

Because it is not the business of the Board to value companies, it follows that it is not the business of the Board indiscriminately to “fair value” assets and liabilities of companies in the mistaken belief that they are nothing more than the net-asset-value sum of their balance-sheet parts. Particularly is this so when investors not only are not asking for what the Board is providing them but by word and deed are rejecting it.

¹⁸ See, e.g., Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises* (November 1978), ¶ 28, in which the FASB formally committed itself to serving “external users who lack the authority to prescribe the financial information they want from an enterprise” (investors rather than regulators).

¹⁹ Concepts 8, ¶ OB7.

²⁰ During the depths of the recent crisis, former FASB Chairman Robert Herz defended fair value accounting for securities held by banks in Congressional testimony. He reasoned that a FASB staff analysis revealing that 52% of all U.S.-listed commercial banks were trading below tangible book value at November 3, 2008 suggested that investors “viewed bank net assets as overstated, not understated, as would be the case if fair value adjustments were causing excessive write-downs of bank assets.” Testimony of Robert H. Herz, FASB Chairman, before the U.S. House of Representatives Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities, March 12, 2009 (full text of testimony), pp. 11-12.

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In numerous comment letters, Sandler O'Neill has documented that investors oppose much of the Board's agenda.²¹ Rather than revisit that documentation in this letter, we offer as evidence of investor sentiment a fact of investor behavior so widely known and accepted that before a court of law it would benefit from *judicial notice*, the cognizance of certain facts as requiring no proof because they are beyond dispute.

That fact is the consistent primacy that investors accord the income statement rather than the balance sheet, and their routine exclusion of the unrealized securities gains and losses of other comprehensive income from operating earnings. For investors, OCI and AOCI represent an unhelpful disconnect between performance and equity and an unwelcome distraction in the financial statements from what matters most to them.

What investors want in the financial statements themselves are good, clean numbers that do not require them to reverse-engineer ephemeral or speculative "fair values" before using the financial statements to reach an investment conclusion, and as certainly they do not want the issuers in which they are invested gratuitously put in harm's way by the volatility of such "fair values" in earnings or equity.²² Investors are not indifferent to the fair value information contained in OCI and AOCI, but it belongs in the notes, not on the face of the financial statements.

The Board's Supervisory Imperative

In their origins the CMED and CLED, as well as the insurance contracts project, respond not to investor sentiment that fundamentally different accounting treatments are needed but, rather, reflect the Board's own implicit but unmistakable judgment that more shadow supervision of reporting entities is required. The proofs of this supervisory imperative are

²¹ See August 31, 2010 letter to FASB (financial instruments); December 15, 2010 letter to FASB (insurance contracts); March 28, 2011 letter to FASB (impairment); July 29, 2011 letter to SEC (accounting convergence and due process, with reference to financial assets, impairment, and insurance contracts). See also Sandler O'Neill's March 31, 2008 letter to the SEC urgently requesting emergency impairment guidance to alleviate the deepening financial crisis.

²² See generally "Accounting for Investors: The Fundamental Importance of Corporate Earning Power," Address of SEC Chairman Jerome N. Frank before the Eighth Annual Meeting of the Controllers' Institute of America, October 10, 1939, in which he remarked at page 8: "The accountant, that is, supplies *some* of the materials for, some of the ingredients of, the investor's judgment. The ingredients he supplies should, therefore, be as pure as possible; but the investor's judgment (or that of his advisers) cannot be compounded solely of those ingredients, nor can the accountant be asked to do the work of the investment analyst. It is, accordingly, essential to emphasize the importance of good accounting, but a mistake to over-emphasize it to the exclusion of many other factors. I distinctly do not mean that the accountant is to forecast future earnings. I do mean that he should give greater recognition to the fact that the principal interest of the investor and his advisers is future prospects – earnings [emphasis in original]."

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both external – regulators rather than investors have the Board's ear – as well as internal in that supervisory rather than accounting ends are fashioning means within the projects themselves.

External Proofs

Like the Board's overwhelmingly and almost universally rejected May 2010 proposal, the CMED would greatly expand the fair value accounting for financial instruments begun in SFAS 115, the genesis of which the Board itself identified as regulators:

This Statement was undertaken mainly in response to concerns expressed by regulators and others about the recognition and measurement of investments in debt securities, particularly those held by financial institutions. They questioned the appropriateness of using the amortized cost method for certain investments in debt securities in light of certain trading and sales practices.²³

In point of fact, however, the accounting culprit-in-chief of the 1980s thrift crisis was not amortized cost or the gains trading it enabled but, rather, the recognition by U.S. GAAP and the federal thrift regulator of goodwill as an asset, and by the federal thrift regulator of supervisory goodwill.²⁴ By 1984 goodwill and supervisory goodwill, not historical cost accounting, largely enabled one-fifth of the thrift industry – with over one-third of its assets – to avoid reporting insolvency.²⁵

To assess how consistently U.S.-regulated banks hold investment securities in the AFS portfolio to generate recurring income rather than to realize gains, we surveyed net unrealized gains and net realized gains on AFS securities as a percentage of total AFS securities from the year SFAS 115 was adopted in 1993 through 2011.²⁶ Appendix A

²³ SFAS 115, ¶ 2. A subsequent study by the research manager and a board member of the FASB documented that the Securities and Exchange Commission was the regulator most responsible for the FASB's adoption of SFAS 115. See L. Todd Johnson & Robert J. Swieringa, "Anatomy of an Agenda Decision: Statement No. 115," *Accounting Horizons*, vol. 10, no. 2 (Sarasota: June 1996), p. 145.

²⁴ Whereas goodwill represents the acquisition premium paid in excess of the fair value of assets of a solvent firm, supervisory goodwill represented the fair value excess of liabilities over assets in the acquisition of an insolvent thrift recognized not by U.S. GAAP but by regulatory accounting principles ("RAP") applied by the Federal Home Loan Bank Board, predecessor agency to the Office of Thrift Supervision, itself recently abolished by the Dodd-Frank Act.

²⁵ See Lawrence J. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation* (Oxford U. Press, 1991), pp. 86-87, Table 5-10 in particular.

²⁶ We prepared Exhibit A for our September 6, 2012 Basel III comment letter to the federal banking agencies opposing their proposed inclusion of unrealized gains and losses on available-for-sale securities in the regulatory capital of U.S. banks.

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presents the results of this analysis, expressed as a median rather than a mean to minimize distortion that extreme outliers would otherwise cause.

The results are a compelling empirical validation of the banking business model in practice: while net unrealized gains are volatile, net realized gains are remarkably stable over time at a fractional amount of unrealized gains. What emerges from this analysis is a persuasive portrait of banks that do not trade securities in their AFS portfolios but, rather, generally hold them for the collection of contractual cash flows. Such sales as do occur likely reflect prudent management practices, including portfolio rebalancing and the defensive sale of rapidly prepaying mortgage-backed securities at a gain today rather than being repaid at par tomorrow, capturing otherwise lost cash flows.

The impetus for the CLED similarly lay not with investors but with regulators, who again misdiagnosed the contribution of an accounting convention to a financial crisis. Specifically, the incurred-loss impairment models in use during the recent financial crisis were criticized for (i) not recognizing losses soon enough, (ii) not incorporating information forward-looking enough to encompass the lifetime of assets and complete economic cycles, and (iii) not providing a uniform approach to the impairment of similar assets.²⁷

As we document in Appendix B, the problems of the recent financial crisis did not result from an inability to reserve for probable credit losses proactively enough.²⁸ Rather, as our empirical analysis of surviving banks demonstrates, the fundamental failure was underwriting. For the best-performing banks, reserves remained adequate to cover nonperforming assets. For the worst, NPAs quickly and dramatically overwhelmed reserves. Needless to say, banks that failed performed much worse than the worst surviving banks.

Any bank capable of apprehending the magnitude of expected losses for the worst-performing assets during the financial crisis simply would not have originated or acquired those assets. Thus, the crux of the problem was not an incurred- versus expected-loss approach to reserves but, rather, that the financial system was awash in too many assets for which no reserve methodology would have been adequate. For the best banks, incurred-loss reserving worked just fine, and for the worst banks no impairment methodology would have helped because the fundamental failure was one of underwriting, not reserving.

²⁷ See Basel Committee on Banking Supervision, *Guiding principles for the replacement of IAS 39* (August 27, 2009), p. 3; see also SEC Office of Chief Accountant & Division of Corporate Finance, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study of Mark-To-Market Accounting* (December 30, 2008), p. 6.

²⁸ We prepared Exhibit B for our March 28, 2011 letter to the Board commenting on an earlier iteration of the CLED.

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Undue regulatory influence is also evident in the Board's work on accounting for insurance contracts, which requires some commentary here because of their exclusion from the scope of the CMED. Begun in 2002 by the IASB and joined by the Board in 2008 as a joint project, the evolving project would radically transform financial reporting by insurance companies and just as radically complicate both equity and debt investments in them by applying an onerous version of theoretical fair value accounting to insurance contracts. The IASB had originally considered FV/Ni recognition but recoiled from the inherent earnings volatility, as the FASB in 1993 recoiled from the earnings volatility inherent in SFAS 115 as originally conceived.²⁹ Like the FASB then, the IASB now has chosen to propose a FV/OCI category for certain fixed-income assets rather than return to first principles to question the wisdom of the undertaking.

The model the IASB originally proposed is fully compatible with Solvency II, sometimes called "Basel for insurers." In the long and tangled history of its insurance contracts project, the point here is not whether the IASB took its cue from European insurance regulators or vice versa, but, rather, that a proposed theoretical accounting model that European regulators are comfortable with is diametrically opposed to the real-world needs and preferences of investors, and thus profoundly at odds with the due process to which both boards have committed themselves.³⁰ Although the boards are not fully converged in their approaches, the fact that the FASB has scoped insurance contracts out of the CMED signals that core features of their pending proposals will be congruent.

Internal Proofs

The Board explains its issuance of the CMED as an attempt to address the "inherent gaps and inconsistencies" of the "existing accounting model for financial instruments" to provide "investors with more useful, transparent, and relevant information about an entity's exposure to financial instruments . . . while reducing the complexity in accounting for those instruments." The Board adds that its "main objective . . . is to provide financial statement users with more decision-useful information about an entity's involvement with financial instruments."³¹

²⁹ See SFAS 115 at pp. 11-13 for the views of dissenting board members Sampson and Swieringa, who believed that all securities within its scope should have been reported at fair value with unrealized changes in fair value included in earnings.

³⁰ We document insurance investor opposition to the boards' joint project in our July 29, 2011 letter to the SEC Office of Chief Accountant commenting on its May 26, 2011 staff paper *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: Exploring a Possible Method of Incorporation*.

³¹ CMED, p. 1.

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The features of the proposed update, however, demonstrate persuasively that its subliminal agenda is extending the reach of shadow supervision rather than making more and better information available to investors. More specifically, the agenda is to get more fair value onto the face of the financial statements, where it will coerce business models to conform to the Board's vision of risk management, and more information into the notes, where it will be audited.

The Board's use of the phrases "exposure to financial instruments" and "involvement with financial instruments" signal as much. More particularly, the terms "exposure" and "involvement" connote risky contacts and illicit activities rather than investments and holdings about which investors need information. This is not the neutral language of accountancy but the morally charged terminology of public health and law enforcement – in short, shadow supervision.

Most broadly, the proposed ascendancy of the contractual cash flow characteristics of financial instruments as the primary arbiter of classification and measurement reflects a long-standing animus toward "accounting based on intent" dating back to SFAS 115.³² Accounting based on intent implies a focus on business models and strategies as the primary determinant of accounting conventions, as does the terminology the Board proposes to jettison: held to maturity, available for sale, and trading. The CMED relegates business models to an operational back seat.

Such a focus lends itself to consigning more financial instruments to the FV/NII or FV/OCI categories regardless of business strategy, particularly when accompanied by the proposed replacement of the available-for-sale category (FV/OCI) with the trading category (FV/NII) as the default classification.³³ This replacement is symptomatic of how radically OCI has sundered the previously ineluctable linkage between earnings and equity in classical accounting thinking and literature, clean surplus accounting in particular.

By contrast, in the IASB's exposure draft the business model is the primary determinant of classification and measurement, not cash flow characteristics. That this is not a distinction without at least a temperamental difference is clear from the fact that under the IFRS 9 proposal an entity may make an irrevocable election to measure equity securities at FV/OCI rather than at FV/NII, which is not permitted under the FASB proposal.³⁴ This exception to FV/NII measurement of equity securities under IFRS 9 may

³² See CMED at ¶ 825-10-25-16 & SFAS 115 at ¶ 27.

³³ See CMED at p. 2: "Financial assets that qualify for neither [AC nor FV/OCI] would be measured at fair value with all changes in fair value recognized in net income."

³⁴ See *Classification and Measurement: Limited Amendments to IFRS 9* ("IFRS 9 ED") (November 2012), ¶¶ 4.1.1 & 4.1.4, which refers to IFRS 9, ¶ 5.7.5. International Financial Reporting Standard 9: *Financial Instruments* (October 2010), ¶ 5.7.5 provides: "At initial

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reflect the fact that investment in equity securities is much more common in foreign than U.S. banks. However, investment in equities is very common (and sometimes large) in insurance companies both here and abroad, with the result that the CMED will significantly increase earnings volatility for many U.S. insurers.

The fingerprints of shadow supervision are also visible in the CMED's inconsistencies and rigidities. For example, before SFAS 115 securities were accounted for by analogy to loans as held for investment at amortized cost or held for sale at the lower of cost or market ("LOCOM"), providing flexibility in the management of both loans and debt securities because the "investment" holding period was not synonymous with maturity. In a complete historical reversal, the CMED proposes to account for loans by analogy to securities under SFAS 115 as held to maturity at AC or available for sale at FV/OCI. As a result, financial institutions could not preserve AC treatment for loan portfolios without a significant loss of flexibility in managing them.

The perpetuation of held-to-maturity strictures in the AC category is evident in the contradictory hedging treatment for debt securities and loans, prohibiting hedging the interest rate risk of the former but not the latter.³⁵ Such inconsistent treatment undermines the conceptual credibility of including loans within the scope of the CMED because it simply preserves the less favorable status quo ante for securities rather than providing a more flexible hedging treatment. As well, although loans and securities measured at AC could be sold because of significant credit deterioration in the instrument, sales to manage credit risk concentrations and changes in risk profile or appetite would be inconsistent with the AC category, as would sales to manage liquidity.

Taken as a whole, the rigidities that hem in the AC category appear calculated to make it extremely difficult for management to elect that classification for many otherwise eligible financial instruments.³⁶ The practical effect of the proposal would be that loan portfolios would be classified FV/OCI or FV/NII, significantly expanding the reach of fair value – hence shadow supervision – and increasing the equity and, for some loans, earnings volatility of entities with large loan portfolios, including most banks and many insurers. Finally, the absence in the CMED of an explicit "tainting" concept for unsanctioned sales of assets from the AC category would be of limited benefit because it merely substitutes prospective for retrospective disqualification of assets for the AC category.³⁷

recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument . . . that is not *held for trading* [emphasis in original]."

³⁵ The contradictory treatment extends to both fair-value and cash-flow hedging. See CMED-CD, ¶ 815-20-25-43 (c)(2) & (d)(2), at p. 142.

³⁶ See CMED ¶¶ 825-10-55-30 to 825-10-55-34.

³⁷ See CMED ¶¶ 825-10-55-33, BC132.

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No discussion of the supervisory agenda informing the CMED would be complete without mention of the exclusion from its scope of insurance contracts, for which there is no principled basis in the proposal itself. Under the CMED, financial liabilities generally would be measured at AC unless they are held with the objective to transact subsequently at fair value or they result from a short sale.³⁸

We can't imagine a class of liabilities more eligible for AC treatment under the CMED than insurance contract liabilities. The insurance business model is to hold rather than extinguish these liabilities early, and to such an extent that there is no market value for insurance contracts other than private market value. As a result, discount rates for such liabilities are extremely speculative, and because they are material to the balance sheets of insurers and have durations of up to 40 years or more, small quarterly changes in these discount rates would create volatility that would overwhelm other sources of earnings and equity.

So at odds with the conceptual foundation of the CMED is the exclusion of insurance contract liabilities from its scope that the conclusion of a supervisory motive is unavoidable. It is precisely because of this volatility that the IASB originally proposed to apply FV/NI measurement and recognition to insurance contract liabilities, and that both the IASB and the FASB are now committed to FV/OCI measurement and recognition, having retreated from the early determination to include the volatility in net income. Speculative information for investors about the volatility of insurance contract liabilities is not the goal, for it could be provided in the notes or MD&A. Rather, the goal is to coerce insurers to conform to the boards' supervisory vision of risk measurement and management, to which end the IASB has proposed amending IFRS 9 to include a FV/OCI category for certain fixed-income assets.³⁹

In its proposed addition of an FV/OCI category to IFRS 9, the IASB is following in the footsteps of the FASB in SFAS 115. History is repeating itself, but with far more damage in the insurance contracts project because of the loss of decades of comparable industry and company information and the extreme difficulty or impossibility of reverse-engineering clean, comparable numbers from the proposed fair value model for insurance contracts in order to reach investment conclusions. Such actions in the name of accountancy are unthinkable, betraying the heavy hand of shadow supervision.

As we mentioned earlier of the credit losses proposal, the CLED is less symptomatic of shadow supervision because fair value orthodoxy did not blind the Board to the wishes of investors and other constituents for a simpler approach. The result is a proposal that

³⁸ CMED ¶ 825-10-35-10.

³⁹ See, e.g., IFRS 9 ED, ¶¶ IN1, BC29 & AV12.

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addresses the putative “too little, too late” deficiency of incurred-loss impairment guidance by reflecting management’s current estimate of expected credit losses without the complexity of the IASB’s credit deterioration model. It also has the advantage of leveraging reporting entities’ existing internal credit risk management systems and tools. Finally, it helpfully harmonizes accounting for originated and purchased credit impaired financial assets by simplifying accounting for the latter.

Nevertheless, in its proposal the Board plays supervisor to the IASB’s accountant. More specifically, the Board’s characteristic focus on the balance sheet and its goal of immediately recognizing all (lifetime) expected credit losses on the balance sheet is essentially a supervisory perspective on loss recognition: the more and the sooner, the better. By contrast, the IASB’s model, with its focus on matching the recognition of interest income and credit expense in the income statement until credit deterioration becomes significant, is more of an accounting perspective.

To conclude our exposition of internal proofs of shadow supervision, we turn from fair value orthodoxy to the companion belief in universal audit. The expression of this belief is the relocation of as much information as possible from MD&A to the notes, where it will be audited, and as much financial information as possible from the notes to the face of the financial statements, where it will most effectively coerce business models. Examples of universal audit at work include both unrealized temporary gains and losses and credit losses on financial instruments, as well as insurance-contract liabilities, discussed herein. Another example is the Board’s project on going-concern disclosures, which would require the substance of various disclosures now in MD&A to be consolidated in the notes, subjecting them to audit.

The Board’s recent discussion paper on its disclosure framework opens a window on the consequences of universal audit.⁴⁰ The paper confirms the extent to which OCI and AOCI have eclipsed revenues and expenses in determining the presence and presentation of financial information on the face of the financial statements, evident in the complete break with traditional accounting of the fair value model for insurance contracts. The paper’s emphasis on the cash flow characteristics of capital instruments to the exclusion of business models implies transforming the role of the notes to financial statements from providing context for historical results to predicting the future value of an issuer’s capital instruments.

So universal is its belief in audit that the Board assumes that even disclosure decisions should be documented and audited, despite the fact that because of managements’ intimate knowledge of their businesses and what really matters, they rely heavily upon

⁴⁰ See footnote 13 above for the citation to the paper and a link to our comment letter.

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intuitive rather than conscious reasoning in making disclosure decisions.⁴¹ As we observed in our comment letter on the paper, had Shakespeare been subject to such a regimen, he would have written few sonnets and no plays.

A Way Forward

Speaking the year after the FASB's creation, SEC Commissioner A. A. Sommer, Jr., warned:

If significant numbers of the accounting profession (and industry and users) refuse to recognize the superior claims of the Board's determinations, or if they accept them hesitantly and grumblingly, then the Board will have lost one of the main supports necessary for its existence.⁴²

The Board stands at a crossroads, perhaps not yet of mutiny but certainly of "hesitant and grumbling" acceptance of its determinations by investors, preparers, and others in a number of projects. The risk to the Board is that it finds itself increasingly presiding over not generally accepted but generally *tolerated* accounting principles. Few developments would be more corrosive to the respect and support the Board requires to be effective in its work.

⁴¹ See Question 11 for Respondents in the Discussion Paper, at ¶ 4.37: "Reporting entities would need to document the reasons for their decisions about which disclosures to provide. How would reporting entities document the reasons for their disclosure decisions and how would auditors audit those decisions?"

⁴² "The SEC and the FASB: Their Roles," Address at Accounting Day, University of Washington, Seattle, January 21, 1974, pp. 7-8. Commissioner Sommer had just remarked: "The FASB, like its predecessors, derives its power to impact financial reporting from two sources: one, the support of the profession . . . and its willingness to accord the Board's determinations sufficient acceptance, and two, the willingness of the Commission to accept for filing financial statements prepared in accordance with its determinations." While the relationship between the SEC and the FASB is sometimes described as a "delegation," Sommer observed at page 7: "The decision is not a delegation of authority. It has rather been a willingness to permit the accounting profession to develop accounting principles and reporting standards, always with the understanding that the final authority remained in the Commission to determine whether the practices and principles adopted by the accounting profession and reflected in financial statements filed with the Commission were consistent with the Commission's conceptions of what was necessary for the protection of investors." For its most recent statement on its relationship with the FASB, see SEC, *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, April 25, 2003, available at <http://www.sec.gov/rules/policy/33-8221.htm>. The SEC supported the creation of the FASB, and had supported development of accounting principles within the private sector dating back to 1934. See John C. Burton, SEC Chief Accountant, "The SEC and the Accounting Profession: Responsibility, Authority and Progress," Address at Accounting Colloquium III, University of Kansas, May 10-11, 1973, p. 10.

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Unfortunately, investors and preparers in large numbers are already alienated by the direction the Board is taking in its financial instruments and insurance contracts projects, so the question becomes how to change course to avoid deeper disaffection and heal damage to the Board's credibility already done.

The answer is easier in the credit losses project because fair value is offstage. Here, the fundamental task before the Board is the principled determination of the extent to which unconfirmed credit losses should be covered by reserves rather than capital. We believe the Board should return to its earlier inspiration that what should be recognized in current earnings is all reasonably estimable credit losses expected to occur in the foreseeable future.⁴³

Capital, rather than the allowance, is and should remain the cushion against possible future losses. On the spectrum of incurred, expected, and possible credit losses, the more distant the time horizon over which losses are estimated, the less "expected" and the more merely "possible" they become. Beyond a horizon of 24 months at most, and more commonly between 12 and 18 months, credit losses become so speculative that best practice and common sense suggest committing them to coverage by capital. Sufficiency of capital should be determined by the capital markets (aka investors) and by supervisors in regulated industries, not by accounting boards.

Such an approach is highly operational, differing from current practice chiefly in the substitution of expected for incurred losses. Immediately recognizing in current earnings credit losses expected in the foreseeable future minimizes any arguable need for discounting and allocating them, thereby better promoting accuracy, transparency, and comparability. It would also reduce penalties for banks arising from Basel III's capital treatment of loss reserves and related deferred tax assets. We urge the Board and the IASB to converge on this approach as a middle ground that would better serve both investors and preparers than either of their separate approaches.

Classification and measurement of financial instruments is more difficult because here fair value orthodoxy is center stage. Despite that difficulty, for the sake of investors and preparers, as well as the FASB and the IASB, the following urgently needs to happen.

First, the FASB should converge with the IASB classification and measurement model under current rather than proposed IFRS 9, which is very close to U.S. GAAP prior to SFAS 115. Information on unrealized gains and losses on securities and loans not held for sale or trading should be presented in the notes to the financial statements rather than on the face of the financial statements themselves. More specifically, the categories

⁴³ By contrast, the existing impairment model recognizes in current earnings only credit losses that are probable to have been incurred.

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under a converged approach to classification and measurement should build on the binary distinction between financial instruments held for investment at AC and held for sale at FV/Nl as a means of improving the practical significance and certainty of financial information presented on the face of the financial statements. Unrealized gains and losses on financial instruments are most relevant to the performance of the business model when they are held for sale rather than investment.

Second, in their joint insurance contracts project, both the Board and the IASB should turn from radically revising accounting for them to converging on targeted, incremental improvements to current U.S. GAAP in a manner that would salvage the utility of decades of company and industry data, not only for U.S. investors and insurers but also for foreign investors and insurers that are reporting pursuant to U.S. GAAP. Such improvements would include, but not be limited to, more timely adjustment of assumptions underlying reported results.

Such a roadmap for cooperation would align international standard setting with the needs of investors and preparers by converging on the most helpful aspects of U.S. GAAP and IFRS, thereby enhancing the esteem of the boards in the eyes of their constituents. We conclude by emphasizing that our recommendations to the Board (and the IASB) do not depend on convergence, which would be a natural outcome and added benefit of each board's rededication to putting investors first.⁴⁴

Sincerely,



Joseph Longino
Principal

cc: The Honorable Paul A. Beswick, Chief Accountant
U.S. Securities and Exchange Commission

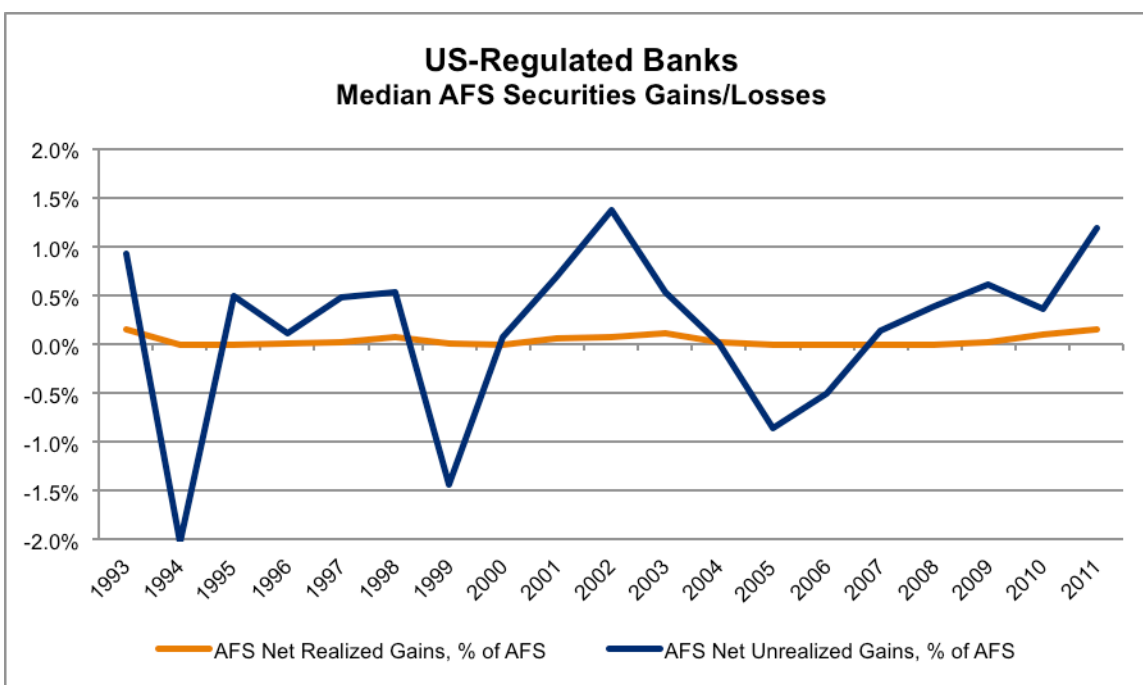
The Honorable Hans Hoogervorst, Chairman
International Accounting Standards Board

The Honorable Michel Prada, Chairman
IFRS Foundation Trustees

⁴⁴ By contrast to the primacy of substantive due process in serving investors, there is but a single passing reference to convergence in the FASB's Concepts Statement No. 8. In that Statement, convergence clearly is what it should be: a secondary, aspirational principle of action to be given effect *only* if consistent with its primary desideratum, accounting for investors.

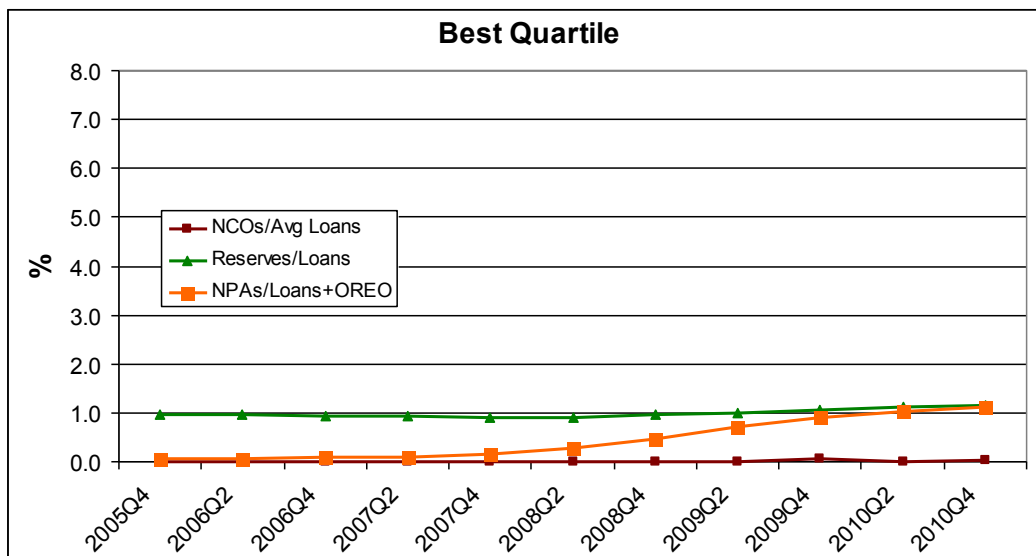
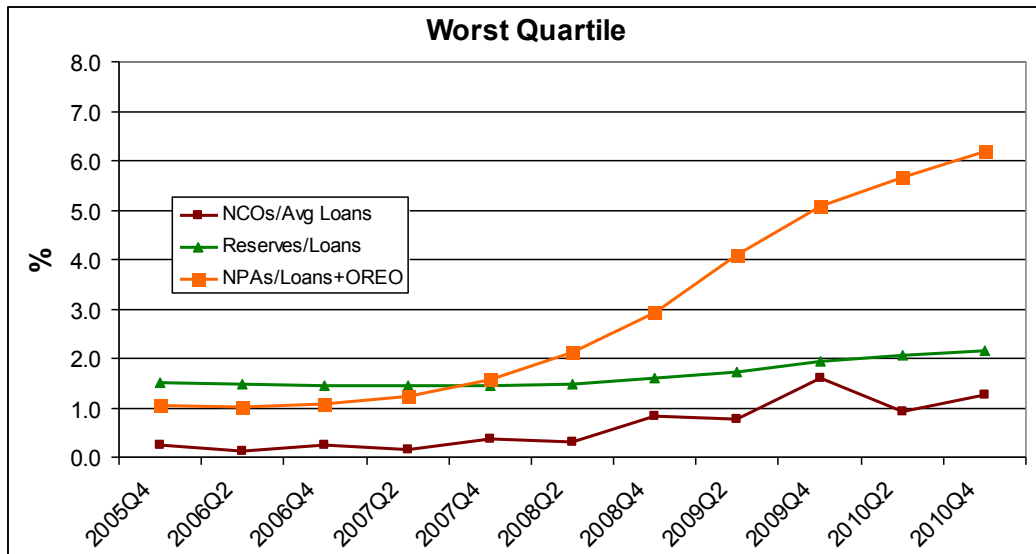
APPENDIX A
AFS Net Gains, Realized & Unrealized

US-Regulated Banks		1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Median AFS Net Unrealized Gains, % of AFS		0.9%	-2.0%	0.5%	0.1%	0.5%	0.5%	-1.4%	0.1%	0.7%	1.4%	0.5%	0.0%	-0.9%	-0.5%	0.1%	0.4%	0.6%	0.4%	1.2%
Median AFS Net Realized Gains, % of AFS		0.2%	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%	0.1%	0.1%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%



Source: SNL Financial

APPENDIX B
Financial Crisis Bank Impairment Metrics



Source: SNL Financial

For each reporting period, we assumed banks in the worst quartile had the highest NPAs, NCOs, and reserves, and that banks in the best quartile had the lowest NPAs, NCOs, and reserves. We also assumed banks exhibiting these characteristics would be relatively stable cohorts over time even though their constituent members may not be identical from period to period. Banks included are all banks and thrifts reporting at year-end 2010.