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March 26, 2009



LETTER OF COMMENT NO. 190

BY EMAIL & FIRST-CLASS MAIL

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Financial Accounting Standards Board
c/o Technical Director
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LETTER OF COMMENT NO. 238

Re: Proposed FSP FAS 157-e
Proposed FSP FAS 115-a, FAS 124-a, & EITF 99-20-b

Members of the Board:

On behalf of Sandler O'Neill + Partners, L.P., I am commenting on proposed FASB Staff Position FAS 157-e, *Determining Whether a Market Is Not Active and a Transaction Is Not Distressed*, and proposed FASB Staff Position FAS 115-a, FAS 124-a, & EITF 99-20-b, *Recognition and Presentation of Other-Than-Temporary Impairments*, both issued for public comment on March 17, 2009.

Sandler O'Neill is a full-service investment banking firm focused on the financial services sector.¹ Our clients include a wide variety of financial firms, among them hundreds of banks and thrifts and their holding companies. Thus, we address the FASB not as accountants but as a firm of financial professionals who work closely with many financial firms as they cope as best they can with accounting guidance ill-adapted to their business models, particularly in the current environment.

On behalf of our clients, one year ago we wrote urgently to the Chairman of the Securities and Exchange Commission requesting "emergency interpretive guidance for determining fair value and assessing other-than-temporary impairment in the context of the extraordinary current market dislocations." Documenting those market dislocations, we warned that the application of fair value and other-than-temporary impairment guidance had created an "accounting vortex" that, "feeding on itself and gathering strength," threatened the United

¹ For further information on Sandler O'Neill + Partners, L.P. see <http://www.sandleroneill.com/>.

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States financial system.² A copy of our March 31, 2008 letter to the SEC is available on our website at <http://www.sandleroneill.com/pdf/1Q08FDQ.pdf>.

We briefly review this history because of its relevance to the critical juncture at which we have arrived. Against great odds, the Federal Reserve Board, the FDIC, and the Treasury Department, supported by the Congress, have so far averted the swamping of the U.S. financial system. However, heavy seas lie ahead, and the FASB must help steady the boat.

Only clear and committed action by the FASB in providing constructive guidance for determining fair value and other-than-temporary impairment will provide public accounting firms the support they need to have the confidence to work with their audit clients rather than exacerbate the current crisis.

Proposed FSP FAS 157-e

Determining inactive markets & distressed sales. The factors in paragraph 11 for identifying an inactive market are appropriate, and the rebuttable presumption in paragraph 13 that a sale in an inactive market is a distressed sale is helpful. However, rebuttal of that presumption by evidence that there was sufficient time “for usual and customary marketing activities for the asset” and there were “multiple bidders for the asset” will result in few presumptions of distressed sales withstanding rebuttal regardless of the brute fact that the sales are distressed.

Distressed sales in even the most inactive, dysfunctional markets, such as the current market for pooled trust preferred securities, are typically characterized by usual and customary marketing as well as multiple bidders, but at levels that “motivated but not forced or otherwise compelled” sellers³ would not and do not accept.

A far better rebuttal of the presumption of a distressed sale would be the existence of a quoted price or prices (recent transaction(s) or broker price quotation(s) [¶ A1]) in an inactive market that imply yields more typical of the security in normally functioning markets, taking into account the risk profile of the security. Like the proposed guidance, such an approach relies upon evidence as

² We copied the SEC’s Chief Accountant and the FASB’s Chairman on our letter, and on April 18, 2008 in Washington, DC, we met with the SEC’s Chief Accountant to urge the SEC to help avert what we believed was a clear and present danger to our imperiled financial system.

³ Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (Sept. 2006), ¶ 10.

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well as judgment and would more unerringly rebut only unjustified presumptions of a distressed sale.

Determining an appropriate discount rate. The guidance in paragraph 15 must be revised for reasons of clarification, and possibly substance. Ambiguity dogs the language of the paragraph requiring that the discount-rate input to a present value technique “reflect all risks inherent in the asset, including a reasonable risk premium for bearing uncertainty that would be considered by willing buyers and sellers in pricing the asset in a non-distressed transaction at the measurement date.”

If this language means that the risk premium should reflect market-participant assumptions not only in a non-distressed transaction but also in an active (normally functioning) market, then it must clearly and completely state this rather than imply it. Otherwise public accounting firms and their audit clients will continue to be at loggerheads over the application of GAAP, and the Board will not have accomplished its goal.

On the other hand, if the language means that the risk premium should reflect market-participant assumptions in a non-distressed transaction in an inactive (abnormal and dysfunctional) market, then the guidance represents no improvement over existing guidance. Like current guidance, it would vitiate present value analysis, hobbling its power to provide an intrinsic-value alternative to valuation based on quoted prices in dysfunctional markets.

Paragraph A32E(3) of the proposal supports the latter, unhelpful reading of paragraph 15 by identifying reasonable assumptions regarding liquidity and nonperformance risks as those associated with “an orderly transaction based on *current* market conditions” [emphasis added]. As a result, many public accounting firms will understandably regard the FASB as once again employing a convoluted construct to choose market pricing in dysfunctional markets over fair value as determined by present value analysis reflecting normalized, functioning markets, and in fact the FASB appears to have done so in the proposed guidance.

Proposed FSP FAS 115-a, FAS 124-a, & EITF 99-20-b

Turning to proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b, the crux of its construct is helpful but not nearly helpful enough.

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The proposed guidance. Applicable to both debt and equity securities, paragraph 12 provides that an other-than-temporary impairment exists with respect to an impaired security if the investor intends to sell the security or it is more likely than not that the security will be sold before recovery of its cost basis. Here, the entire amount of the impairment would be recognized in earnings.

Applicable to debt securities only, paragraph 13 provides that an other-than-temporary impairment exists for an impaired security (whether available for sale or held to maturity) if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the security even though it is more likely than not that the security will not be sold before recovery of its cost basis. Here, the amount of impairment related to credit losses would be recognized in earnings, with the remainder of the impairment recognized in other comprehensive income.

Paragraph 12 reflects long-standing GAAP and strikes us as reasonable. However, paragraph 13 is a half measure that would do little to quell escalating debate over the held-to-maturity portfolio between some public accounting firms and their audit clients. Because of its difficulty of application in both the held-to-maturity and available-for-sale portfolios, paragraph 13 would foment continued conflict between public accounting firms and their audit clients over the causes and corresponding attribution of impairment amounts.

A better alternative. In lieu of proposed paragraph 13, the Board could help immensely by reverting to the impairment guidance of FASB Statement No. 115 as it was commonly understood and applied prior to EITF Issue No. 03-1.⁴

Specifically, the Board should adopt guidance providing that a debt security is other-than-temporarily impaired *only* if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the security. The entire amount of any such impairment should be deemed to be credit-related and recognized in earnings, with subsequent recoveries of impairment also recognized in earnings. (To do otherwise would perpetuate existing perverse accounting incentives to make uneconomic decisions with respect to impaired assets.) Impairments unrelated to credit losses should be recognized in other comprehensive income for available-for-sale securities, and for held-to-maturity securities such impairments should not be recognized in either other comprehensive income or earnings.

⁴ Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (May 1993); EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (March 2004).

Effective Date & Transition

Both proposed FASB Staff Positions, revised as requested herein, should be applied prospectively for interim and annual reporting periods ending after March 15, 2009 to all securities existing at the effective date. A transition adjustment for impairments of securities in prior periods should be recognized as a cumulative-effect adjustment to the opening balance of retained earnings or other appropriate components of equity or net assets in the statement of financial position for the period of initial application.

The Nexus of Business Models, Accounting Principles, & Investors

In his March 12, 2009 Congressional testimony, FASB Chairman Herz defended fair value accounting for securities held by banks. He reasoned that a FASB staff analysis revealing that 52 percent 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."⁵

The fundamental flaw in this line of reasoning is that banks are not mutual funds, and investors in banks do not look to accounting principles applied to them for daily net asset values for purposes of redemptions. Rather, investors typically focus on expected future earnings instead of book value in the knowledge that banks and thrifts manage not to total return but to the spread relationships between earning assets and funding liabilities. As Chairman Herz acknowledged, "loans held for investment, which make up the bulk of financial assets for many banks, are carried at amortized cost subject to loan loss allowances that are not based on fair value" (p. 6).

What Chairman Herz failed to acknowledge is that banks often own large portfolios of securities that are also held for investment, and that there is no principled basis in GAAP for applying different guidance on fair value and impairment to such securities given the counterexample of loans. Debt securities are merely certificated loans, and thus easier targets for proponents of fair value who give short shrift to the common business reason for holding each.

⁵ Testimony of Robert H. Herz, Chairman, Financial Accounting Standards Board, 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.

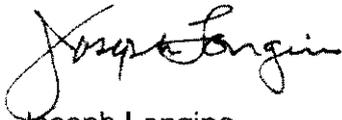
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The disheartening irony in the context of our current economic and market travails is that although many securities are less liquid than loans, the Board seems reluctant to embrace fully the constructive use of present value techniques commonly applied to loans to determine the fair values of illiquid investment securities.

Very truly yours,



Joseph Longino
Principal

cc: Office of the Chief Accountant
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