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Re: No. 1810-100: Accounting for Financial Instruments and Revisions to the Accounting for Derivate Instruments and Hedging Activities

Dear Mr. Golden:

The following comments regarding the Financial Accounting Standards Board's ("FASB") exposure draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivate Instruments and Hedging Activities* ("Proposal"), are submitted on behalf of the Independent Bankers Association of Texas ("IBAT"). IBAT is a trade association representing approximately 500 community banks domiciled in Texas. Most of IBAT's member banks are family owned or closely held and several are publically traded.

FASB has proposed that most financial instruments, such as loans and loan commitments, debt and equity securities, and noncore deposit liabilities, be measured and reported on a bank's balance sheet at fair value. IBAT's community bank members, along with a majority of other banks, strongly oppose the portion of the Proposal that requires all financial instruments to be marked to market and requests that the Proposal be withdrawn. If implemented, the Proposal will have a serious negative impact on the most critical element of a bank's financial statements – its capital. Whether referring to Tier 1 regulatory capital, tangible common equity, or total capital, regulators and depositors who are interested in safety and soundness, as well as investors who analyze return on equity and forecast future capital needs, focus closely on these balances. Adoption of the Proposal will result in recognizing net income changes in the fair value of most assets and liabilities on a bank's balance sheet, as well as will force the decline in reliability of reported bank capital, both of which will lead to unprecedented volatility in community bank earnings and equity.

Given the lack of support for this Proposal – from the International Accounting Standards Board ("IASB"), to the Financial Stability Board, to the federal banking regulators and to institutional bank investors – it is difficult to understand why FASB believes such a Proposal should be adopted. At the very least, it is illogical to apply such a drastic accounting change to the banking and financial industry but not to use the fair value model for all

assets and liabilities for all industries. If the Proposal is adopted, community banks will yet again be singled out for economic results that they did not cause.

### ***The Proposal Will Not Improve Transparency of Financial Information***

Community banks are not mutual funds, and equity investors in community banks do not look to the accounting principles applied to community banks for daily net asset values for purposes of redemption. Instead, investors typically focus on a community bank's expected future earnings because they have knowledge that community banks manage not to total return but to the spread relationships between earning assets and funding liabilities that are in place primarily to generate spread income. Thus, the Proposal to expand fair value accounting would degrade rather than improve the transparency of financial reporting by community banks because fair value focuses on the liquidation values of assets and liabilities rather than their capacity to generate recurring spread income. Requiring the determination of fair value of a community bank's assets not only greatly increases the expense of rendering financial statements but also creates significant cost and time problems across the banking enterprise. These consequences are on top of the significant implementation costs that community banks will be forced to bear if the Proposal is adopted.

In addition, the fair value of loans held for long-term investment is already reflected in bank financial statements as footnotes. Thus, the information is readily available to any investor that seeks this information. It is appropriate to keep such information as a footnote disclosure because many assets on a community bank's books, especially those in rural areas, do not have an active market. Because an actual fair value determination is subjective, judgmental and not a true picture of an asset's worth, any fair value assigned to an asset is not reliable and is not a true picture of the asset's value. The numerous complexities and subjectiveness required to determine the fair market value of an asset and to recognize and report the same will vitiate any hoped-for transparency or usefulness of information. Furthermore, the potential for abuse increases. Most community banks will be forced to "make up" an imaginary market in which to sell assets that in actuality have no market, and most fair value determinations will reflect a lower value of the asset.

Furthermore, because this information is not relevant to how community banks generate their cash flows, this information is appropriately disclosed in footnotes. The Proposal, in effect, will change the performance measure for community banks to that unrelated to the management of credit. As a result, FASB's attempt to improve transparency will change how community banks are managed and how they are evaluated by investors.

The additional information and enhanced information systems capabilities necessary to do the required reporting, along with implementation costs, will also have the consequence of imposing a significant cost on community banks. Most community banks' accounting and reporting systems are not currently designed to handle the changes in the Proposal. Compliance with the Proposal will require the hiring of additional staff and in many cases the hiring of outside consultants to provide valuation assistance. Community banks will be forced to expend significant funds to implement and comply with the changes – funds that would otherwise and better be spent to provide needed credit to their communities. Thus, fair value accounting acts as a punitive measure to community banks.

### ***Investor Confusion***

The Proposal will also mislead users of community bank financial statements. Where loans are not sold, to reflect a fair value as part of capital is to mislead the financial statement user. Because of today's significant market volatility, this misperception will be exacerbated – further damaging community banks' ability to lend. From an investment perspective, it is illogical to affect bank capital by changes in the market that may never be realized by the bank. As a result, unnecessary volatility will be introduced into the market and confidence in bank capital will decline.

Even though a secondary market exists for residential mortgage backed securities, which offers a relatively standardized starting point for valuation, the secondary market for commercial assets is small and much less reliable as a starting point for valuation. The Proposal essentially asks community banks to speculate as to commercial assets' values, which does not produce a reliable metric for investors to evaluate. And, because most commercial loan markets are inactive, estimating the fair value for a commercial loan often requires a significant liquidity discount. The reliance on individual modeling in order to determine fair market value on commercial assets, which contain standard and non-standard terms, will likely confuse investors. Investors will be required to understand and comprehend numerous assumptions, which will vary from bank to bank, in order to properly evaluate a bank. Investors will also need to understand how banking models determine interest rate, credit, and liquidity discounts across wide ranges of product lines and geographic areas.

Moreover, the fair value of an asset does not depict its true value to a community bank, as the fair value determination excludes the value of other products and services that are critical to the total customer relationship. Because of this effect, as well as the greater knowledge community bankers have about a borrower's overall credit, the value of the loan is greater to a community bank than it is to an outside party. All of these factors make it nearly impossible and confusing for an investor to attempt to compare institutions based on the fair value of assets.

This confusion will only be compounded with the necessity to determine a reciprocal fair value measurement of deposits, including a core deposit intangible asset ("CDI"). However, the Proposal does not use a fair value measurement. Rather, a present value method to estimate the CDI, that will exclude certain major factors such as customer relationships, is included in the Proposal. This calculation will conflict with the current methods to recognize and measure CDIs within an entity, and financial statement users will be required to either differentiate between the two values or completely relearn what the CDI represents in a community bank's financial statements. Further, many smaller community banks, often located in rural locations, do not have access to alternative funding sources to determine core deposit valuations. Media reports will increase the confusion to community bank depositors who learn that their accounts will be recorded on their banks' books for amounts less than the deposits' principal balance. To the average depositor, this distinction will cause more confusion and fright than benefit.

### ***The Proposal Will Result In Reduced Community Bank Product Offerings***

Additionally, an increased cost of capital coupled with higher operational costs will lead to reduced product offerings that would otherwise be subject to greater fair value volatility, such as loans with long-term fixed interest rates or loans to those persons with lower credit scores. If these product offerings are not eliminated, then interest rates will have to increase to account for the increased volatility in fair market value. Alternatively, community banks will be forced to offer more variable rate products, which is contrary to the best interests of many community bank customers and contrary to guidance from federal banking regulators. The Proposal may also affect community banks' non-loan product offering. As community bank customers hear media reports of fair value losses or deficits, they may believe their deposits are at risk and take their business to another institution. In short, these consequences will exacerbate the current state of the economy and could wreck havoc in the housing market and larger economy as a whole. It should not be the role of accounting to drive community bank product offerings or to limit financial choices.

### ***The Proposal Will Increase Procyclicality***

The Proposal will introduce additional systemic risk into the financial system by unnecessarily adding to the volatility of bank capital. Thus, procyclicality in the financial system, which is contrary to the goals of the federal banking regulators, will increase. Whether linked to regulatory accounting or not, procyclicality both adds to the cost of capital and exacerbates financial cycles. By causing community banks' performance to be based on factors that are unrelated to credit risk, such as with the significant liquidity discounts that have been prevalent since the beginning of the financial crisis or

with the routine movements in interest rates, community banks' performance becomes a result of factors unrelated to their business and irrelevant to investors who seek long-term capital growth. Although marking deposit liabilities to market may ease a portion of the volatility caused by interest rate movement, this practice can actually increase the problem in times of economic contraction – like today.

We have specifically seen during 2007 and 2008 that procyclicality can severely damage the economy, and subjecting community bank financials to the extreme volatility experienced in the last few years completely ignores the fact that community banks are unique in their responsibility to serve illiquid markets while having deposits available for immediate withdrawal. If the market's long-term efficiency is advocated, the effect of short-term inefficiencies that can irreparably harm community banks must also be equally weighed and considered. The Proposal will further damage our economy's ability to emerge from recession or may tip our economy back into a recession.

### ***The Proposal Will Not Allow Community Banks To Do What They Do Best***

Community banks take pride in working with borrowers to solve problems in repayment. If a borrower demonstrates financial difficulty, the typical community banker does not sell the loan; instead, the typical community banker works out the loan with the customer. The work out process may involve modified payment terms, additional collateral provided by the customer, or changes to the customer's operations in order to meet the payment schedule. The market does not build into the market price resolution of modified lending terms. The value of the loan is rarely realized through an immediate sale. Therefore, the market value is irrelevant because the loan will never be sold. Community banks need the ability to maintain flexibility in modifying lending terms to best serve their customers and to best manage cash flows for purposes of investor analysis.

### ***The Business Accounting Model Is An Appropriate Accounting Method***

The business accounting model is a more appropriate method to apply: financial instruments managed for fair value and trading purposes should be accounted for at fair value, while those managed for long-term investment in order to collect the contractual cash flows should be accounted for at amortized cost, with a vigorous impairment model. The business accounting method reflects how a bank will generate its future cash flows – a fundamental indicator for banks. It also reflects how well a bank is managed, which is a more relevant measure for bank investors.

### ***Conclusion***

In conclusion, full fair value accounting for core banking activities, which has been consistent and unwavering for over twenty years, should not be implemented for the following reasons: (1) fair value accounting is not relevant to the banking model and will not increase transparency; (2) fair value accounting will undermine the reliability in bank capital levels, decrease an investor's ability to compare multiple banking entities, and will cause greater investor confusion; (3) fair value accounting will impose significant costs on community banks with little or no benefit to users of bank financial statements and will decrease product offerings; (4) fair value accounting will add unnecessary procyclicality to the financial system; and (5) fair value accounting will prevent community banks from following their business models.

The Proposal is simply not supported by those that FASB claims want fair value treatment of bank assets: the banks do not support the Proposal, as evidenced by the many comment letters already filed on the Proposal by both banks and the bank trade associations; the institutional investors in bank and other financial firms who participated in FASB's two-hour roundtable on the Proposal do not support it; the federal banking agencies do not support it, including the FDIC's Chairwoman, Sheila Bair, who opposes the Proposal as evidenced by her recent interview with Steve Forbes; and the International Accounting Standards Board does not support it. Furthermore, both the G20 and the Basel Committee on Banking Supervision recognized the issues surrounding pure fair value accounting, and as a result, recommended to the IASB that its accounting method applied to financial

instruments should be based on the business model. Contrary to what is stated in FASB's Proposal, across-the-board fair value accounting for all financial instruments does not reflect a bank's business model.

Costs to community banks, and as a result to the economy, will be enormous. FASB should leave in place its current guidance for classifying, measuring and reporting financial instruments, including changes in fair value, interest income and expense and realized gains and losses – to make changes otherwise is without merit, reactionary, and will do more harm than good to the economy. In 1991, the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") required that bank supervisors use standards at least as stringent as those in GAAP. Effectively, with FDICIA, Congress delegated the power to regulate accounting standards for banks to FASB. Along with this power came the immense responsibility to balance the needs of investors with the safety and soundness concerns of bank regulators and the general public. Recognizing that FASB is an unappointed, unelected, powerful entity, we respectfully urge it to maintain this balance, take into account all interested parties' comments regarding fair value accounting, and to withdraw the Proposal.

Sincerely,

A handwritten signature in black ink, appearing to read "Christopher L. Williston". The signature is written in a cursive, flowing style.

Christopher L. Williston, CAE  
President and CEO