

September 29, 2010

Technical Director  
File Reference No. 1810-100  
Financial Accounting Standards Board  
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Via Electronic Mail to [director@fasb.org](mailto:director@fasb.org)

RE: Exposure Draft of Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

Dear Sir / Madame:

I appreciate the opportunity to comment on the exposure draft of Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (“exposure draft”).

The theory of complete mark-to-market accounting (“MTMA”) is intellectually appealing. It seems to promise factual and current information for investors to assess the performance of a financial company. Unfortunately, MTMA suffers a fatal flaw when extended from theory into practice. In order to be valid, active markets must exist for value to be determined. The less liquid the market, the less valid the market values that are the foundation of MTMA.

This concept has been proven over the past two years, with the demise of many financial firms being directly attributable to the application of MTMA to securities for which no market existed at the time. The accounting rules then in effect essentially equated illiquidity to near-zero value, with disastrous results for firms such as Bear Stearns, Merrill Lynch and Lehman Brothers. Only due to threatened legislative action were amendments made that eased this assumption, effectively replacing MTMA in some cases with mark-to-model accounting.

With the exposure draft of Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities, FASB is proposing to institutionalize mark-to-model accounting. This should not be confused with mark-to-market accounting. To illustrate this, I use the balance sheet of the bank for which I work in the example below:

	<b>Balance</b>	<b>Market Value Available</b>
<b>Assets</b>		
Cash and cash equivalents	129,896	Yes
Securities available-for-sale	216,934	Most
FHLB and FRB stock	13,690	Model
Loans held-for-sale	9,823	Yes
Net loans	1,818,071	Model
Premises and equipment, net	56,505	Most
Other real estate owned	47,128	Yes
Mortgage servicing rights, net	2,344	Model
Bank-owned life insurance (BOLI)	50,876	Yes
Other assets	117,492	No
Total assets	2,462,760	
<b>Liabilities</b>		
Deposits:		
Non-interest bearing demand	327,599	Model
Interest bearing:		
Savings, NOW, and money market	991,125	Model
Time	832,295	Model
Total deposits	2,151,019	
Securities sold under repurchase agreements	20,379	Yes
Short-term borrowings	4,860	Yes
Junior subordinated debentures	58,378	Some
Subordinated debt	45,000	Model
Notes payable and other borrowings	500	Model
Other liabilities	19,098	No
Total Liabilities	2,299,234	
<b>Total stockholders' equity</b>	163,526	
Total liabilities and stockholder's equity	2,462,760	

Only approximately 18% of assets and less than 3% of liabilities can be valued from market quotations. Even assets such as mortgage servicing rights, which are currently held at “market value”, are essentially valued by model because very few transactions involving MSR’s have occurred during the last year.

This is where the theory and the reality diverge. MTMA proponents cite the theoretical benefit of better investor information provided by MTMA. In reality, for the vast majority of assets and liabilities on our balance sheet, there is no mark-to-market value, only mark-to-model value instead. It is important to recognize the distinction. MTMA proponents will argue that MTMA reflects current economic reality. That is a true statement if market quotations reflecting the potential for actual transactions are available. It is not true when value is a derived number that is based on assumptions that could potentially vary significantly from one firm to another, and could even vary significantly for a given financial instrument.

As a basis for disclosure of estimated market value, mark-to-model can provide useful information although it may be misleading when comparisons between firms (and therefore assumptions) are made. As a basis for establishing carrying value for assets and liabilities, it fails in its promise of a clearer financial picture while introducing needless earnings and capital volatility. As an alternative to the exposure draft proposals, we suggest the following approaches to financial accounting:

1. Mark-to-market/model can convey some useful information. Therefore, require an expanded value disclosure along the lines prescribed in the exposure draft. That disclosure could even include "Economic Value of Equity", which is a common regulatory term for the difference between the economic value of all assets less the economic value of all liabilities plus the market value of off-balance sheet instruments. Note the term "economic value" reflects the difference between the concepts of mark-to-market and mark-to-model.
2. Over the years, a patchwork of inconsistent rules has affected financial accounting. In effect, the same set of cash flows may be held at cost or mark-to-market depending on arbitrary rules. We would propose eliminating such disparities by re-establishing historical cost as the accounting basis for financial assets and liabilities, including off-balance sheet instruments.

It is important that the FASB recognize the gravity of their proposal in the context of the overall economy. The accounting methods embodied by the exposure draft would be highly pro-cyclical and would likely result in the failure of firms during times of economic distress, thus exacerbating the economic downturn. We have no clearer evidence of this than the past two years.

While it would be unfair to implicate MTMA as the cause of this most recent recession, history is clear that the magnitude of the downturn, and the fate of many financial firms that would otherwise be in existence today, would have been much less severe had it not been for MTMA. It is no surprise that a parallel between the Great Depression and the Great Recession was the application of MTMA at the time. Given the incredible social and economic cost that has been paid over the past two years, it is vital that FASB recognize its contribution to that cost and understand that the exposure draft proposals would only lead to even greater such costs in the future.

We believe our proposals enumerated above serve to meet the needs of investors who desire better information based on some market information (only some because so much will be based on mark-to-model), while maintaining historical cost as the accounting basis to avoid the extreme pro-cyclicity embodied by the exposure draft proposals.

Sincerely,



Stan C. Faries  
Former Asset/Liability Management Consultant and current Bank Officer