



September 23, 2010

Russell G. Golden, Technical Director  
Financial Accounting Standards Board- FASB  
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Via email: [director@fasb.org](mailto:director@fasb.org)

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Dear Mr. Golden:

Thank you for the opportunity to comment on FASB's Exposure Draft: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities. I am currently the Treasurer of First Federal of Bucks County, a \$600 million community bank with 10 branches located in Bucks County, Pennsylvania.

This year marks my 25<sup>th</sup> anniversary in the investment portfolio, asset/liability management, and Treasury fields. I have spent my career studying and calculating prices or market values for all kinds of financial instruments. I have watched FASB's "fair value" progression and selective targeting of parts of the balance sheet since the early 1990s, with FAS 115 for investments and FAS 107 for market value or "fair value" disclosure, with EITFs through the 2000s, and through the expansion of fair value through FAS 157 and FAS 159 in 2007. The devastating impact of having procyclical accounting rules was never more evident than throughout 2008, when the financial crisis was evolving into a full-fledged panic. Mark-to-market accounting led to a downward spiral of fire sale and low, distressed prices and spurred distressed sales of assets, collapsing some markets, most notably the private mortgage backed securities market, spurring more writedowns as prices fell further. Then, last year, when Congress demanded action, FASB relaxed some of the restrictive rules with the issuance of FAS 115a, FAS 124a, EITF 99-20-b, and FAS 157e. It was no coincidence that financial markets began to improve from cyclical lows with the change in some of the onerous fair value rules. Now, today, only two years removed from the worst financial crisis in a generation, your Exposure Draft appears and promotes the expansion of fair value rules to loans, loan commitments, and core deposits. The radical proposals will only multiply the procyclical effects of mark-to-market accounting by throwing trillions of dollars of loans into the mark-to-market mix. In all of my reading and research to prepare this comment letter, I have seen great opposition to your proposal from banking and financial industry groups and have seen almost no support.

### Impact on Capital and the Economy

It is surprising that you would believe that these proposals would be of benefit. I believe that they run the risk of leading to a larger scale downward spiral in market prices once mark-to-market accounting is applied to loan portfolios. Is this a risk that you are willing to take? It will not matter that most banks intend to hold loans and collect cash flows over time, funded by deposits from customer relationships that banks intend to retain for the long term. The needless volatility to earnings and capital will unsettle the markets. Mark-to-market accounting did not cause our financial crisis, but it certainly has exacerbated it. I would further note that with rates at historic "Eisenhower" lows, any mark-to-markets in the next several years on longer term fixed rate loans will be negative ones as prices fall when rates begin to rise. Imagine a Federal Reserve ready to finally tighten monetary policy when the economy recovers, only to have to fight another capital crisis in the banking sector.

The pressure on bank capital from further writedowns on loans from mark-to-market accounting will mean that banks in general will remain slow to lend as we try to recover from recession and financial market crisis. Bank lending is the lifeblood of our economy, and the absence of it today is proving to hold back economic growth. Your proposal would contribute to delayed economic recovery even further. Banks may even reconsider offering longer term fixed rate loans that could cause large value changes as rates change, hurting consumers and businesses which rely on fixed rate funding. The banking industry will also be facing higher capital requirements from the new Basel III initiatives; they could be adding capital, only to see it depleted from writedowns due to accounting rules. This situation has persisted since 2008 and could conceivably grow greater if loans are subjected to fair value rules. FASB continues to experiment with mark-to-market accounting, but at what cost to our economy?

### Balance Sheet Structure Proposal

Your proposal calls for financial assets to be placed into two categories- fair value through net income and fair value through the Other Comprehensive Income, "OCI," component of equity- and for financial liabilities to be placed into four categories- fair value through net income, fair value through OCI, amortized cost, and "remeasurement" value for core deposits. For assets where the intention is to "hold and collect" contractual cash flows, the proposal calls for dual measurement in OCI on both an amortized cost and fair value basis. What could be the reason for such complexity?

This proposal is a radical restructuring of everything we have known our entire banking careers about balance sheets and income statements. Your scheme to use net income, OCI, amortized cost, remeasurement value, and hybrid "hold and collect" rules will be confusing to bankers, investors, shareholders, market participants, and regulators alike.

### Core Deposit Valuation

I do agree conceptually with the "remeasurement" value methodology for pricing core deposits. In fact, I have used a similar methodology in the risk management and asset/liability processes of several banks since the early 1990s. The deposit balances are separated into maturity buckets based on expected runoff or "decay" assumptions. A servicing cost is added to the product rate and the resulting "all-in-cost" is valued against alternative funding source market rates. As a

proxy, I often use interest rate swap rate indications. Your proposal calls the value result of the calculation an “intangible;” I believe the value is quite real and should not be referred to as an intangible, like goodwill or customer lists. We may actually have intangibles outside of the calculation in the ability to cross sell products and services to customers.

In these calculations, we would need to be permitted to use our own internal assumptions, which are necessarily subjective. I can see issues arising with external auditors trying to “tick and tie” every number. I can also see issues arising with comparability. Smaller banks such as ours will tend to have higher fixed costs because we have not attained the scale and number of accounts of larger banks; our “all-in-cost” of products will tend to be proportionately higher and not directly comparable to other banks of varying sizes. With all of this being said, I agree with your methodology, but I do not believe that deposits should be subjected to your fair value accounting rules.

#### Loans and Loan Commitments

I do not believe that loans or loan commitments should be subjected to mark-to-market accounting rules. Most loans are made for the purpose of holding them to maturity and earning income over time. Opportunity costs fluctuate; we know this from experience. Our job is to ensure that customers have sufficient cash flow to service their debt at their committed rate and terms. I believe that the time and money required to make massive systems changes to accommodate these proposed rules, to hire additional staff and perhaps outside consultants, and to educate our team members will exceed the benefit of the proposed financial statements.

Additionally, we are concerned with the overwhelming scope of the proposal and the burden placed on financial staff, which, at our bank, consists of a CFO, Treasurer, Controller, and three other team members. We are concerned with how we would obtain and how much we would have to pay to obtain fair values, discount rates, and credit information in order to meet the requirements of your proposal. As was the case with your previous mark-to-market accounting guidance, there is no ready market for some of our loans and most of our deposits, so assumptions will have to prevail, as they do now in preparing our disclosures. Comparisons of our financial statements among banks will be extremely difficult.

#### Credit Impairment Proposals

Your proposed credit impairment model would force losses to be recognized earlier as the “probable” threshold is removed. I am not entirely sure what you are trying to accomplish with this proposal other than having banks book loans and immediately recognize credit losses in the income statement. Also, having banks consider past and existing conditions, while prohibiting consideration of future conditions, flies in the face of all that we know about economic cycles. Assuming conditions remain flat can and will cause distortions- positive and negative- at economic peaks and troughs, respectively. Even the markets contain information about expectations of future conditions; yield curves contain an inherent projection of forward interest rates at any point in the future and stocks trade on expected price/earnings ratios. You will perpetuate harmful procyclical accounting effects. Most banks would prefer to be able to build reserves during economic good times to be better prepared for economic downturns, when losses rise and raising capital is very difficult. This involves assumptions from management that were

not permitted when you changed loan loss reserving guidance years ago. Now you are willing to accept larger assumptions in the calculation of fair value? The discrepancy does not make sense.

I believe that banks should be permitted to recognize expected credit losses over the life of a loan, through the provision for loan losses, and not as a reduction to interest income. I disagree with your proposal, which would front load credit costs and impairments to the detriment of bank capital. I ask that you reconsider your credit impairment proposals in the context of the loan loss reserve process and consider changes separately.

#### Hedging Changes

I do agree with your desire to change the monstrosity that is hedge accounting for derivatives. Many institutions, including our own bank, have foregone the use of these risk management instruments, due in part to the onerous implications of ongoing accounting that tends to force marking-to-market even if the intention is purely for risk reduction or for gaining funding cost advantages. You desire to change your hedging standard from “highly effective” to “reasonably effective,” although you have not made the meaning of “reasonably” completely clear. However, reduced documentation and less restrictive criteria for an item to qualify as a hedge, avoiding volatile mark-to-markets, will be positives. I ask that you publish this proposal separately, and not tie it to this controversial Exposure Draft, so that hedge accounting relief would be forthcoming.

#### Implementation of Proposal

You propose that these rules would take effect in 2013. You make an exception for non-public entities less than \$1 billion in assets, such as our bank, and grant an additional four years to comply with the loan, loan commitment, and core deposit requirements. This is an inherent admission of the sheer magnitude and complexity of this radical proposal. I certainly would like to know if the benefits you see in implementing the proposal (the nebulous simplicity, reporting improvement, and transparency) outweigh the massive costs. I am not sure you or anyone else has performed this analysis.

I do not agree that the proposal will simplify and improve financial reporting for financial instruments, nor do I believe it improves transparency. Quite the contrary, I believe that the complex accounting treatments based so heavily on assumptions and running through the income statement and the OCI section of equity capital on the balance sheet will confuse and frustrate investors, regulators, users, and preparers of financial statements. I wonder, in a scenario as confusing as that which you propose, how I will ever again be able to project our income statement and balance sheet for risk modeling or budgeting purposes.

#### Mark-to-Market Experiment

Your new proposals surprised me because they contain such complexity and radical change that I wonder whether a proposal like this is appropriate for our economy and our financial system, when we are only two years removed from the worst financial crisis in 75 years and only fourteen months removed from the end of the longest recession since World War II, according to the National Bureau of Economic Research, or “NBER.” Your attempt to push the fair value experiment onto loans, loan commitments, and core deposits will likely cause these markets to suffer a similar fate as your fair value experiments on investments did in 2007 and 2008. Mark-

to-market accounting did not cause the crisis but it certainly exacerbated it as writedowns spurred sales and even more writedowns. We could face another downward spiral if fair value rules are forced upon loan portfolios, with even more devastating consequences.

I strongly urge FASB to withdraw this proposal and to not go forward with the radical changes on the precious balance sheet categories of loans and deposits. Small community banks and many other financial institutions whose primary business is making loans and taking deposits for ongoing spread income are not trading these instruments in the marketplace. Over the past three years, we have seen the seizure of our financial markets and experienced a recession that was deep and harmful, due to many factors converging, including mark-to-market accounting. But this crisis is not without precedent. Mark-to-market accounting has been cited by Milton Friedman as one of the contributors to the bank failures and crises of the Great Depression in the 1930s. In 1938, President Franklin Roosevelt's administration realized the mistake and suspended mark-to-market accounting. (Brian Wesbury 02/09/09). Please reconsider your proposals and the costs and harm that will likely overwhelm any benefits you may see.

Thank you for your consideration of my ideas and views on this very important subject. If you have any questions, please contact me at 215-504-6560 x 160 or by email at [djaworski@firstfedbucks.com](mailto:djaworski@firstfedbucks.com).

Sincerely,



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