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September 24, 2012

Technical Director
File Reference No. 2012-200
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
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File Reference: No. 2012-200 Proposed Accounting Standards Update: Financial Instruments (Topic 825) Disclosures about Liquidity Risk and Interest Rate Risk

Dear Financial Accounting Standards Board:

I appreciate the opportunity to comment on this Exposure Draft (ED) regarding enhanced disclosure requirements for liquidity and interest rate risks. As acknowledged in the ED, these proposed disclosures apply mainly to financial institutions. Accordingly, my response is written solely from the perspective of financial institutions that will shoulder the majority of the increased operational burden associated with preparing the new reporting requirements.

**One of my over-arching concerns is that my profession continues to stray from being historians to creating stories, opening up great chasms from reality. I saw this when FAS 133 came out, and was and continue to be horrified and believe that these types of initiatives open opportunities for fraud and defalcation, such as perpetrated by Enron and WorldCom, among others.**

I have numerous concerns with the ED as proposed. While we explain my specific issues below in more detail, the general nature of my concerns relate to the following items:

- Effective interest rate and liquidity risk management practices are as much an art form as they are a science. In an effort to "standardize" the measurement and presentation of selected components of these disciplines, the proposed disclosures will:
  - result in *inaccurate* representations of risk;
  - send *conflicting messages* regarding risk; and
  - provide a *false sense of "completeness"*;

  thereby increasing the potential for the related risks to be misinterpreted by many financial statement readers; and

- The ED appears to be written with the larger financial institutions in mind, and implicitly underestimates the incremental cost burdens that will be required for the vast majority of the 7,000+ banks in the U.S. (and similar number of credit unions.)

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To fully appreciate the potential operational burdens and costs of supplying the information requested, one must first understand the extent to which the proposed risk measurements and reporting are *additive* to the current risk modeling activities of most financial institutions. Additionally, it is important to understand how/where necessary risk modeling information is sourced and the factors impacting the work effort required to meet financial disclosure deadlines. Once costs are reasonably understood, they must be compared to the utility of the related incremental information being provided within financial statements. *I am concerned about both the cost and the usefulness of the added disclosures.*

I am particularly troubled with the decision to reach out to only 12 banks which, based on FASB's description, appears to have also excluded any meaningful contact with any asset size sector within the extensive community banking space. It is the very institutions that FASB has chosen to ignore (98+% of the banking space) that will absorb an inordinate share of the burden associated with this ED.

I am quite comfortable with these general assertions, and hope that FASB takes the essence of my reasons explained below with an appropriate amount of seriousness. The remainder of this letter outlines some of these issues and then answers specific questions asked to be addressed by the ED.

I would very much welcome an opportunity to engage in a constructive dialogue with FASB regarding my strong feelings, which in reality can only be partially communicated in a comment letter.

**A Note on Liquidity & Interest Rate Risk Management Practices**

All financial institutions are required by regulation to have liquidity and interest rate risk management processes that are *commensurate with the complexity of their business activities*. The processes used to evaluate these risks are typically carried out by qualified personnel, reviewed by senior management, and governed by the board of directors. In the case of numerous community banks these activities include varying degrees of outsourcing (e.g. risk modeling and analyses, and strategy development) to independent third parties. Periodically, the institution's regulatory supervisor performs a detailed review of the process to ensure the institution is operating in a safe and sound manner.

Over the last three years the banking regulatory agencies have issued advisories/guidance that have greatly elevated liquidity and interest rate risk management expectations, resulting in expanded modeling and management/Board reporting requirements. This has also been accompanied by more robust regulatory reviews of these risk management areas.

Accordingly, there has been a marked increase in related costs and resource requirements for the vast majority of financial institutions. I am concerned that these will be exacerbated needlessly by the preparation and audit cost burdens associated with the increased footnote disclosure of risk management information that in many cases is redundant to already available public information, provides a still incomplete risk picture, is misleading to a financial statement reader, and/or is inappropriate in my opinion to distribute outside the organization (examples provided later in this document).

The costs of the proposed ED will add yet another "regressive tax measure" to the community banking sector that had little, if anything, to do with the financial crisis.

**Cash flow Estimation / Modeling: The Source of Information & Challenges**

A quality asset and liability cash flow projection is critical for an institution to comply with the proposed disclosures for liquidity and interest rate risk. More often than not, this information is not something that can be easily extracted from a core processing system without meaningful and regular quality control and scrubbing of data.

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Most core systems do not track maturity or repricing information for large segments of the balance sheet (e.g. bond portfolios or wholesale funding books), and contractual information is often insufficient when assessing the true cash flow characteristics of a financial instrument (e.g. mortgage product cash flow that is influenced by prepayment activity).

Accordingly, the most common source of the cash flow information will be an interest rate risk model.

*The Panacea of Reporting Consistency*
As a firm that runs over 300 client interest rate risk models each quarter and independently reviews hundreds of others annually, we feel strongly that cash flow modeling can (and should) be as much an art as it is a science. Assumptions are critical in shaping cash flow forecasts and influence almost every line item in the model. And those assumptions, typically forward looking and thus difficult to empirically support, will vary widely from one institution to another.

Regulatory guidelines governing the liquidity and interest rate risk management processes long ago recognized that it was virtually impossible to apply a one size fits all model or process for these areas.

While FASB has proposed a standard set of schedules to achieve consistent reporting, the underlying numbers in those schedules will be derived by processes and assumptions that will be anything but consistent. What assumptions did the 58 users of financial statements FASB interacted with in formulating this ED make regarding the consistency and precision with which these disclosure schedules will be prepared? If they became fully aware of the high degree of inconsistency would it diminish their perception of accuracy and therefore utility when reviewing the information?

Given this practical concern of consistency, how much influence is FASB implicitly proposing to exert on the financial institution in supporting the formulation of these schedules? The cost and time required to provide documented support for every assumption would be profound if calculable, voluminous when documented, and potentially harmful to an institution's ability to execute on time sensitive strategic initiatives (particularly concerning and discussed in detail later.)

Accordingly, what level of review would be required by the financial institution's audit firm to opine on the reasonableness of results? I have concerns that because there is no defined standard modeling practice or model assumptions, a financial institution may be encouraged by their audit firm to adopt a change in modeling practice to comply with accounting goals that actually weakens risk management practices.

## Liquidity Disclosure Requirements (Questions & Responses)

***Question 1 – Are there any issues that we foresee with the preparation of a liquidity gap report based on expected maturities?***

> **Response** – Yes; primarily in the non-maturity deposit section of the balance sheet, but also for a number of financial instruments with embedded options (e.g. loans).
>
> Given FASB's focus on consistency and comparability, assumptions presumably have been made regarding the derivation of cash flow data for non-maturity deposits that are available on demand by the customer. While we appreciate the catch-all phrase "use of judgment", there are numerous very real issues surrounding this, especially as they relate to these deposit types.

For example, should the entity report the estimated decay of existing accounts, thereby explicitly reflecting a "liquidity forecast" that projects how it expects to lose *all* of its deposits? If so, is that meaningful without providing *forward looking* expectations for incremental deposit growth and related mix; and is that kind of disclosure appropriate? Alternatively, should the liquidity gap table reflect "expected" decay of average balances (estimated decay on existing adjusted for estimated new growth)?

This also raises an important issue relating to the concept of deposit decay: there is absolutely no industry standard for this exercise. I have seen a broad array of representations of this data throughout the industry with estimated timelines ranging from "immediate" (given the ability of deposits to be withdrawn without notice) to 100% reflected in longer dated time buckets (to capture expectations that a deposit category behaves on average more like a longer term vs. shorter-term source of funding.) Additionally, a number of banks prepare detailed deposit studies, the results of which are utilized to array the decay of deposits along a timeline. Some of these studies are based upon their own data, while others are based solely upon a "black box" industry/peer average. Given this reality what is FASB's expectation of what the expectations of audit firms will be regarding how this should/shouldn't be done and what kinds of substantiation will be required? How will reasonable consistency be ensured amongst the "reviewers", let alone "the preparers?"

Our hypothesis is that the ED will result in banks being pressured by their auditors to prepare a detailed bank specific core deposit study. Very few banks have the capacity to perform any kind of detailed statistical analysis of their non-maturity deposits, so is it FASB's assumption that Banks will need to hire 3rd parties to perform such analyses? At what cost? And has FASB addressed the realities that if the few organizations that are most active in core deposit studies were to perform a study on the same bank, the results would be different because the assumptions, methodologies, logic, etc. differ, and that these differences can be material? If the answer is that institutions should conduct a mathematical study to support the assumption used to prepare the disclosure, has FASB included the $10-$50k cost of the initial study in the cost benefit analysis of the ED? How frequently should it be updated? As an aside, we are one of the providers of core deposit services to the industry and serve to benefit from this. I simply do not believe that FASB should be a catalyst (direct or indirect) for determining what a bank should be doing in terms of managing the risk-return of its business.

A number of issues also arise with many loan types. For example, institutions with large commercial loan books issue Lines of Credit that might have a short-term contractual maturity, but more often than not typically sees the term of the loan extended rather than the loan cash flow. Additionally, the approaches for estimating loan prepayments are anything but consistent and often are based upon observing related security market data as a surrogate for estimating bank specific loan portfolio behavior.

Again, how will reasonable consistency be garnered in dealing with these items on the balance sheet so as to not confuse financial statement users? And does the application of a "consistent method" fairly reflect the liquidity risks of one institution versus another with a completely different business model or local competitive environment?

The list of questions/issues goes on and on, few of which even appear to be anticipated within the ED.

***Question 3 – Does the "Expected maturity" of a financial instrument provide more meaningful liquidity information than "Contractual maturity?"***

**Response** – Based on the definitions in the ED; yes. Bank balance sheets are filled with embedded options for which a mere presentation of contractual maturities is of limited value.

Notwithstanding, the existence of optionality necessitates an understanding of how cash flow will change over time, especially as variables such as interest rates and even consumer behavior patterns change. In effect, a cash flow forecast for an option-laden instrument is scenario dependent and in many cases can produce an infinite number of potential outcomes (e.g. mortgage related instruments). Also, there are a number of financial, consumer and governmental policy variables that can materially impact "expected maturity" information from
one reporting period to the next. Accordingly, forcing a single scenario disclosure of cash flow information is of questionable value.

In other words, it is as equally important to understand the potential variation of cash flow as it is to know the expected cash flow based upon current market conditions. Many risk management practitioners compensate for this variable by performing multiple what if analyses, thereby presenting a far more complete picture of the liquidity risk profile. It would be very difficult to capture this in the context of disclosure footnotes.

Cash flow management is a dynamic process which operates within a world whereby expected cash flows change continuously based on a myriad of factors. As a result, the cash flow related to a static point in time (e.g. quarter end balance sheet) could change meaningfully, for example, if interest rates (levels or yield curve shapes) and even credit/swap spreads changed between the as of financial date and the reporting date. Does this present any concern to FASB regarding the potential disclosure of misleading information? Does this reality increase the probability that banks will be forced by their audit firms to adjust their information "at the last minute" due to significant changes in subsequent events?

***Question 4 – Do you foresee issues in disclosing information regarding liquid assets and available funding lines?***

**Response** - Most information regarding "traditional" liquid assets is already disclosed publicly in regulatory call report filings. The only net add with this disclosure would be available borrowing lines. For the majority of community banks the dependability of the funding lines often hinges on availability of qualifying loan and security collateral, often through the FHLB.

This presents a challenge for the reader of a financial statement when reviewing the disclosure schedules, in that there will be a double counting of liquidity to the extent that borrowing capacity is expressed in the aggregate without regard to the nature of collateral standing behind the funding lines. For example, portions of the security and loan cash flow reflected in the liquidity gap table will also be implicitly included as being available for use in support of accessing funding lines.

It is also important to note that the availability of funding for banks transcends the availability of "liquid assets" and funding "lines" anticipated in the ED. For example, the vast majority of banks have ready access to deposit outlets in the national and brokered arenas that are governed by specific internal bank policy, but are not "guaranteed" in the context of a funding "line."

The implication of these disclosures is that there is an element of completeness to the picture being painted regarding a bank's liquidity position: cash flow and access to funding. The reality is that there are numerous other sources of liquidity not captured in these tables.

***Question 5 – Are there any operational constraints preparing a time deposit table that includes the issuance and cost of time deposits?***

**Response** – Of all the tables discussed in the ED, this one makes the least sense in terms of information an investor should be entitled to. What is the purpose? Regulatory and accounting reports already provide balance trend analyses, but this aspect of the ED requires disclosure about cost of acquisition. This information will be of limited use to an investor, but have much more use to a competitor of the institution in helping better dissect a deposit gathering / business strategy. I see this as being potentially harmful to the reporting entity.

In its "Background Information and Basis for Conclusions" section the ED states that the Board's reasons for the time deposit disclosures were 1) to show the cost of funding for an institution, and 2) help understand how a bank is positioning itself for the future with short-term or long-term financing. Both of these premises are highly questionable.

First of all, why does the FASB single out CDs? What correlation does CD pricing have to a Bank's current total cost of incremental funding? What about other deposit products and wholesale funding decisions at the margin? And why should the details of tactical funding decisions employed in the prior quarter(s) be disclosed in depth? Furthermore, the implication (as noted by FASB) is that CDs represent a significant funding strategy. Does it? For most banks CD balances have been declining substantially during this current economic cycle, by design.

The concept of term structure funding positioning seems to refer to the arena of interest rate risk. Examining a single balance sheet funding component without regards to other funding strategies, asset strategies, and/or the use of hedging strategies tells little about how a bank is positioning itself for the future. Also, in many cases CD term structure decisions are liquidity driven vs. interest rate risk driven decisions.

Finally, the ED references the disclosure of "yield." Does FASB mean CD rate, or is it the intention to provide the impact of compounding in the proposed disclosures? If yield was intentional, FASB should understand that maturity reports prepared by operating systems that would be used in preparing such disclosures do not track/report on a yield basis but rather coupon rate.

***Question 6 – Do the disclosures provide the user of a financial statement a better understanding of an entity's liquidity risk?***

**Response & Overall Conclusion on the Proposed Liquidity Disclosure Requirements** – The reality is that "exposure to liquidity risk" is a continuum that transcends the ED's recommended point in time listing of a single scenario set of balance sheet cash flows, and a partial listing of the vehicles available to a bank for raising cash quickly. The management process and related monitoring, controls and procedures are as important to determining liquidity risk as the level of available liquidity. To state that the objective is to require "disclosure to the extent necessary so that users of financial statements can understand an entity's exposure to liquidity risk" is an enigma.

Effective liquidity management requires an understanding of reliable funding that is available to an organization, a method of forecasting probable net funding demands over a variety of time horizons, the knowledge of what hypothetical events might place a stress on that position, and a contingency plan for dealing with liquidity stress of varying degrees. The regulatory community actively reviews these practices at all institutions and take the current and anticipated future health of the organization into account to best ensure that liquidity is not a factor in bank failure. Should the health of the organization deteriorate, the regulatory community demands much more stringent controls over liquidity.

Disclosure of some of the information requested would be of limited value to an investor looking to purchase stock in a healthy institution, as the strength of capital and earnings already garner a strong institution ample access to funding from multiple channels.

Furthermore, the availability of liquidity is anything but static and can be impacted by third party decisions to pull or reduce lines, increase haircuts on available collateral, and regulatory prohibition or restrictions on accessing particular funding sources.

Knowledgeable analysts of the financial sector understand this process already. I therefore question how expanding the liquidity disclosures as proposed in the ED will add value relative to the cost and burden of preparing the disclosures as proposed. In fact, we believe that the proposed disclosures will be meaningfully deficient in capturing the true liquidity positions of financial institutions for reasons outlined above.

Pertaining to the time periods reflected in the liquidity gap table, we do not understand what appears to be a fixation with aligning cash flow projections with fiscal years. Quite simply, liquidity measurement and management has no relationship at all to fiscal timeframes. It is an irrelevant concept. This will add an unnecessary nuisance factor for aggregating data separately whereby the reconciling aggregation buckets change every quarter.

**Interest Rate Risk Disclosure Requirements (Questions & Responses)**

***Question 13 – Are there any operational concerns or constraints that relate to the preparation of a repricing gap report?***

**Response** – Yes, and many other concerns as well.

The potential problems relate to how some of the actual "standardized data" is to be reflected, as well as the overall utility of a gap report for assessing interest rate risk.

One issue relates to the ED's *literal* definition of "repricing date" as the earlier of the date when the interest rate contractually resets and the date the financial instrument contractually matures. Unlike the "expected maturity" concept detailed in the liquidity risk section, the ED seems to be silent on this within the interest rate risk section. The only qualifying comment appears to be a statement that financial instruments with no contractual repricing dates should be presented in the aggregate in the total carrying amount column (i.e. excluded from the body of the repricing buckets).

This raises a question as to the intention of FASB regarding the presentation of repricing data for interest bearing non-maturity deposits as well as non-interest bearing DDA. Should interest bearing non-maturity products be put in the first time bucket since "contractually" they can be repriced anytime? Since DDA has no repricing or maturity should they be excluded from the time buckets? This confusion is compounded by the fact that the illustrated table presents further conflicting messages with all DDA reflected in the first bucket, and savings and money market accounts spread across multiple buckets.

Is the intention to utilize the same expected maturity concept prescribed for the liquidity gap? If yes, why is this not explicitly stated? If no, then clarification is required for non-maturity deposits as noted, and it begs the question as to why the schedule ignores items such as expected prepayments that do not appear to be covered by the "repricing date" definition. Additionally, a literal interpretation of "when a financial instrument matures" also seems to exclude scheduled asset principal payments. To the extent that the repricing gap ignores the expected maturity concept, the

proposed schedule would become of extreme questionable value. If the answer is no to the expected maturity concept, then how does one reconcile the presentation of repricing data without considering all expected cash flow to the required disclosure of *duration* which is dependent on capturing all expected cash flow? As an aside on "duration", most community institutions will be disclosing a set of numbers implying to financial statement readers that they understand what they mean and that they are utilized by the bank for decision-making. Both of these implications would be misleading.

Notwithstanding the above, gap schedules have become antiquated as a meaningful tool for estimating and managing interest rate risk for the vast majority of banks. While there are a number of reasons, a primary one relates to gap reports only reflecting the cash flow and repricing characteristics for a single interest rate scenario. Therefore, readers of financial statements would need disclosure on multiple repricing gaps to understand the degree to which cash flow and repricing behaviors may vary under different rate conditions; a solution that is impractical.

As noted in the liquidity section, the difference between rate and yield on a gap report (particularly for loans and deposits) makes a big difference in cost burden for compliance.

While most banks rely very little on gap reports, they nonetheless and typically prepare one regularly because a gap report is a standard report generated by asset/liability management software tools. Why not let banks do what many are already doing, which is to present their existing gap report with significant methodology assumptions disclosed? Trying to standardize the presentation by neutralizing judgment related variables and/or forcing data into a schedule in a manner that has little relation to reality, begs the question: why bother? Also, we doubt any financial institution modifies gap reports to correspond to fiscal time periods. This just adds unnecessary noise to an already noise filled schedule.

***Question 14 – Are there any operational concerns or constraints that relate to the disclosure of net income and shareholder equity at risk to interest rate movements?***

**Response** – Yes, and many other concerns as well.

***Net Income Sensitivity***

The ED states that a bank "should not incorporate any forward-looking expectations regarding non-interest revenues, non-interest expenses, tax rates, projections about growth rates, asset mix changes, or other internal business strategies in preparing the interest rate sensitivity analysis."

In other words, the bank is required to prepare a completely new set of financial models and projections for eight different interest rate scenarios for the sole purpose of providing FASB mandated disclosures. *Banks simply do not prepare interest rate risk models in the manner prescribed in the ED.* Candidly, we were a little surprised by FASB's casual mentioning of its acknowledgement that "the proposed guidance *may not (emphasis added)* align with every management team's strategy for managing risk". The reality is that it *will not* for most, if not all of them.

*Flat Balance Sheet*

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I concur with the notion of a flat balance sheet for purposes of isolating current interest rate risk from the noise created by growth assumptions. However, the literal notion of prohibiting *any* changes in mix is not only unrealistic, but also a key contributing variable to the need for maintaining a separate "FASB model". While banks are required by regulation to model earnings sensitivity with a flat balance sheet, the common practice is to incorporate logical changes in mix. For example, these regularly include some of the following sampling of market realities:

- Reallocation of mortgage cash flow from residential products either no longer being offered or no longer being held in portfolio,
- Reinvestment assumptions for security cash flow reflecting current investment strategy vs. a blind replacement into securities no longer being purchased,
- Excess liquidity being utilized to pay off maturing borrowings and brokered/national deposits,
- Banks precluded by regulatory order from renewing brokered/CDARS deposits,
- Maturing longer-term CDs no longer being rolled out on the curve due to customer migration into shorter-term products,
- Short-term borrowing maturities being rolled long per ALCO decisions, or vice versa,
- Etc., etc.

Another problem with the ED "no mix change" edict is that it fails to define the level of aggregation to which the term "mix" applies; therefore, any presumably means any. I shudder to see how this plays out in the field with any degree of consistency.

*Interest Rate Scenarios*

FASB states that "the form and extent of the hypothetical shifts of interest rate curves being proposed would provide consistent information across reporting entities". I believe that it will only provide one consistent set of *data* elements across entities as opposed to consistent *information*.

For example, we have learned from experience that +/-100bp scenarios are insufficient to identify specific meaningful exposure variables in most bank balance sheets. In fact, due to inherent optionality in bank balance sheets we continue to observe that scenarios greater than +200bp in the current environment are required before meaningful information begins to develop. I also question what possible information content and what possible degree of consistency would arise out of a -200bp scenario in this environment.

I question the non-parallel scenarios on two fronts. The first relates to the fact that most commercial banks we observe are impacted the most by yield curve flattening/steepening that occurs within the 2-10 year range, not outside of it as proposed by the ED. In fact the proposed scenarios embed a parallel shift in yield curves between these end points. The second relates to the first. By selecting a non-parallel yield curve scenario with an embedded step function at one point of the curve FASB opens up the very real possibility of "adverse selection" in which the selected scenarios overly penalize or under capture the likely impact of shifting yield curve shapes on any particular institution.

An additional variable relates to the requirement that all interest rates (and presumably rollover/reinvest rates on all asset/liability repricings and cash flows) reflect rates existing at the "as of" financial date. Given that varying degrees of time can pass between a quarter-end and the date that an updated interest rate risk model is executed, it is common for banks to use current market information when preparing the earnings simulations. For example, if market rates have moved with an impact on security reinvestment rates and wholesale funding rates, or pricing changes have been implemented for selected deposit or loan products, these variables are often rolled forward. This further contributes to the necessary requirement that two sets of interest rate risk books be maintained

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(one for management and one for FASB disclosures), or that management migrate to the FASB disclosure methods because of cost/time considerations (thereby resulting in FASB determining rather than reflecting management practices.)

I also noted FASB's comment that one of its aims with the proposed disclosures was to "prescribe the nature and amount of the shock to interest rates *that an entity should consider* (emphasis added) in its analysis." I were surprised to learn in this ED of the extension of FASB's Mission into the realm of deciding what constitutes best practices for managing balance sheet risk at financial institutions.

*Model Preparation Cost Issues*

Although most financial institutions employ a variety of technologies to help facilitate the construction of their interest rate risk model (internally and/or through a third party ), the actual exercise of building these models is still a laborious process. With limited exceptions models are built using detailed data from their operating systems and instrument level processing of these data files. While manual data entry is minimal, developing a strong interest rate risk model and accurate repricing gap requires a thorough review of source data integrity, financial statement reconciliations, assumptions building (e.g. prepayment estimates, call/put options, deposit lives/betas), and quality control within software systems.

As noted earlier, meaningful elements of the required data cannot be easily extracted from core processing systems. In most cases this necessitates the obtaining of data/information from third parties for information relating to items such as prepayment estimates for loans and scenario based cash flows for the investment portfolio. The most common sources of the cash flow information will be an interest rate risk model, data made available through the broker dealer community, or data emanating from other sources such as Yield Book (investments). There is a cost for expanding the number of scenarios for which related data is required and models need to be run.

Given the discussion above, it should be clear that banks will bear both hard and soft dollar costs associated with the maintaining of a separate single purpose set of financial models in order to comply with the ED.

*As of Date Risk Metric Disclosure Issues*

Given the resource challenges, especially timing associated with preparation of current SEC risk management related disclosures, many institutions conduct this lengthy modeling activity on "off-quarter" balance sheets to ensure sufficient investment is made in the quality and accuracy of these models. Otherwise, they risk violating deadlines for 10K and 10Q reporting as well as other important quarter/year end administrative obligations.

Accordingly, we recommend 1) offering financial institutions explicit flexibility to distinguish between the <u>financial reporting date</u> and the <u>IRR disclosure date</u> and 2) establishing limits on disparities between the two dates (e.g. 60-days).

*Forward Looking Earnings*
I also question FASB's election to require banks to disclose a forward looking 12 month Net Income number within the financial statements, especially without a single disclaimer noted. Even with disclaimers, why force banks to provide a forward looking earnings number when it seems like every public disclosure, press release, etc. issued by banks goes out of its ways to warn against forward looking information?

Any disclosures should be represented as a % change from an undisclosed base case level of earnings assuming no change in interest rates. These disclosures should be based on the already voluminous extent of analysis being prepared currently by most banks. For example, we currently run 11 different scenarios (analysis paralysis) with almost half of them stemming from regulatory expectations. If the ED requires the bank to report information in a manner that enables a reader to understand its risk profile, then why not let the bank decide (and ultimately defend) what scenarios and disclosures it deems to be the most useful?

***Shareholder Equity***

As proposed, the concept of shareholder equity at risk is somewhat confusing as a measure of interest rate risk. It has nothing to do with expressing or understanding an institution's enterprise interest rate risk. It merely captures the potential impact of rate changes on an accounting definition of shareholder equity, including the effects of other comprehensive income. For the vast majority of community banking institutions this will be limited to an estimation of the impact of changes in the value of Available For Sale securities and to a much lesser extent cash flow derivatives hedges.

Given the proposed changes in regulatory capital definitions, this would provide insight relative to the impact of rate changes on selected regulatory capital ratios.

Other than calculating (likely from 3rd parties) the impact of the proposed non-parallel yield curve scenarios, the actual reporting burden should be minimal. Notwithstanding, the manner in which this information is presented in the sample schedule is problematic in that it reflects volatility in equity without context. Additionally, it reflects a specific dollar amount of impact for selected rate environments that will never flow through to equity in the manner represented. In other words, it is the impact of rate changes on the entire balance sheet (current and future earnings mainly) that will ultimately determine the impact on equity.

At best, we believe this type of information should be disclosed as individual component pieces, enabling an informed reader to build/calculate the shareholder number if desired, rather than post a number conducive to being misinterpreted.

***Question 15 – Do the proposed disclosures provide sufficient information for users to understand the interest rate risk position?***

**Response** – No, for many of the reasons already noted previously in this letter.

The gap analysis offers little to no value for users of financial statements and the prescribed earnings scenario analysis, as drafted, is not consistent with the manner in which most financial institutions measure interest rate risk.

Asset/liability management experts (banking regulators included) recognized long ago that gap analysis offers little utility in its capacity to assess interest rate risk. In different rate scenarios, asset and liability cash flows may vary meaningfully and embedded cap/floor contracts will restrict repricing activity for variable/adjustable rate balance sheet items (e.g. adjustable rate mortgages). Also, some reflected volumes reset upward and some downward in rate at repricing / cash flow. Additionally, gap report placement of non-maturity deposit balances (typically, some of the largest balance sheet items) is highly subjective given the lack of contractual repricing and maturity dates. As a result, gap analyses commonly lead to false conclusions regarding mismatch risk and potential margin/earnings sensitivity.

Regulatory bodies have agreed with this position for a long time and now discount the relevancy of gap schedules in formal interest rate risk management guidance as well as CAMELS ratings.

*In this regard, my recommendation would be to eliminate the repricing gap as an element in the IRR Disclosure Requirements, or enable banks to disclose their existing gap report (as many already do).*

While we are strong advocates for earnings based simulation analyses, with the goal of gauging potential meaningful changes in margin/earnings levels under reasonable and plausible rate scenarios, we believe the prescribed rate scenarios in the ED, as currently drafted, offer only limited value to users of financial statements and is inconsistent with the approaches most commonly used to measure interest rate risk. I also find the extremely restrictive constraints surrounding how the balance sheet mix must be maintained to be particularly troubling (as explained above in Question #14).

***Question 16 – Would the repricing gap analysis in paragraphs 825-10-50-23Y through 50-23AC provide decision-useful information in the analysis of financial institutions?***

**Response** – No. I believe the repricing gap offers little to no value in helping users of financial statements understand and assess interest rate risk.

Again, as stated in the response to Questions #13 and #15, gap analyses commonly lead to false conclusions regarding mismatch risk and potential earnings sensitivity. Even with the use of multi-scenario schedules, financial statement readers are likely to find it difficult to interpret the interest rate risk implications of gap analysis.

While gap reports are typically prepared by banks, their utility primarily relates to developing strategies related to items such as the timing and nature of upcoming CD and other term funding maturities, volumes and give-up yield on security cash flow, and potential impact on loan strategy given expected loan cash flow/repricings.

***Question 17 – Are the proposed time intervals in the repricing gap table in paragraphs 825-10-50-23AB through 5-23AC appropriate to provide decision-useful information about the interest rate risk to which a financial institution is exposed?***

**Response** – To answer this question would imply that we believe that repricing gap analysis in paragraphs 825-10-50-23Y through 50-23AC provide decision-useful information in the analysis of financial institutions. I do not.

However, as noted above in Question #13, we do question the value of adjusting for fiscal years. This seems to imply that the disclosure is trying to enable the user to draw conclusions about fiscal year earnings forecasts, when as noted previously the gap is greatly problematic in this regard.

***Question 18 – Do you think that sensitivity analysis of shareholders equity would provide more decision-useful information than would a sensitivity analysis on economic value?***

**Response** - I am not sure how to respond since the two metrics are akin to comparing apples and oranges. As noted in Question #14, shareholder equity at risk captures the potential impact of rate changes on an accounting definition of shareholder equity, including the effects of other comprehensive income. In other words it examines a very limited set of balance sheet items. Economic Value of Equity (EVE) on the other hand incorporates an assessment of interest rate changes on the entire balance sheet. The only thing they really have in common is that they are

value-based metrics. By definition, the decision-useful information cannot be meaningfully compared.

A potential problem with reporting EVE is that it is an interest rate risk measurement metric that bears little relationship to book value of equity, regulatory capital, market capitalization or franchise value. I fear that financial statement readers may attempt to estimate the value of a financial institution based on the economic value of equity (EVE) disclosures.

Additionally, and without making this a tutorial on EVE, there are materially different sets of pertinent assumptions utilized when preparing an earnings based model vs. a value based model. For example, while earnings sensitivity models are dependent upon replacement assumptions for all assets and liabilities, these assumptions are irrelevant in an EVE model. While an EVE model forces a terminal decay of the entire balance sheet, including deposits, the earnings model described by the ED forces a maintaining of existing balance sheet size and mix (in effect, mandating a forecasted transaction in the form of reinvestment/rollover activity). As a result, an analysis of EVE sensitivity often conflicts with earnings based sensitivity models.

**Concluding Comment**

I am not in favor of the specifics of the proposed Exposure Draft on liquidity and interest rate risk disclosures on a number of fronts. As noted above we do not agree with the core premises of the ED, have severe reservations regarding the misleading nature of the proposed disclosures, and believe that mandating a reporting consistency that attempts to ensure meaningful comparability of bank interest rate and liquidity risks amounts to little more than fool's gold.

As a final thought, we can't help but observe an interesting irony in the proposed solution for ensuring reporting consistency:

> In an effort to create consistency, the ED mandates a reduction in subjectivity surrounding the calculation of estimated risk for a financial institution.
>
> Given that any risk measurement system requires meaningful assumptions and subjectivity, the reduction of subjectivity by FASB increases the probability that the presented risk measures (especially interest rate risk) will be misleading relative to the bank's actual assessment and management of its risk position.
>
> This in turns increases the probability that preparers will need to rely on the ED's catch-all fall back of providing additional qualitative disclosures.
>
> So, if the logical extension of the prescribed approach increases the likelihood that preparers will need to supplement the required disclosures with qualitative disclosures, why not just start *there* and allow banks to disclose what they believe to be the most meaningful information for helping users reasonably understand its risk management position and related risk management practices.

This will enable financial institutions to utilize the volumes of existing risk measurement data they are already preparing and for which they are already paying.

This is particularly important for the community banking space that has been unfairly burdened with too many "regressive tax" measures. This FASB Exposure Draft will unnecessarily add to the pile.

M&F Bancorp, Inc.

Sincerely,

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