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Technical Director  
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Financial Accounting Standards Board  
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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:

We 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. First Federal Bank is a \$3.3 billion publically-traded financial institution headquartered in Charleston, South Carolina.

Following are our responses to the questions in the ED, as well as general concluding comments.

#### **Liquidity Disclosure Requirements (Questions & Responses)**

***Question 1: For a financial institution, the proposed amendments would require a liquidity gap table that includes the expected maturities of an entity's financial assets and financial liabilities. Do you foresee any significant operational concerns or constraints in complying with this requirement? If yes, what operational concerns or constraints do you foresee and what would you suggest to alleviate them?***

**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, securities, FHLB advances, etc.). There are too many issues surrounding historical trends, forward-looking expectations, stress scenarios, deposit decay (which has no industry standard, and generally must be calculated by a third party at an additional cost to the bank), loan renewal/roll-over rates, loan prepayments, mitigating strategies, etc. that go in the assumptions. These vary between institutions and may be too judgmental in nature to truly present a liquidity risk profile without disclosing numerous scenarios and presenting a relative sensitivity analysis.

**Question 2: For an entity that is not a financial institution, the proposed amendments would require a cash flow obligations table that includes the expected maturities of an entity's obligations. Do you foresee any significant operational concerns or constraints in complying with this requirement? If yes, what operational concerns or constraints do you foresee and what would you suggest to alleviate them?**

**Response** – N/A

**Question 3: The proposed amendments would require information about expected maturities for financial assets and financial liabilities to highlight liquidity risk. Expected maturity is the expected settlement of the instrument resulting from contractual terms (for example, call dates, put dates, maturity dates, and prepayment expectations) rather than an entity's expected timing of the sale or transfer of the instrument. Do you agree that the term expected maturity is more meaningful than the term contractual maturity in the context of the proposed liquidity risk disclosures? If not, please explain the reasons and suggest an alternative approach.**

**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. However, 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). Accordingly, forcing a single scenario disclosure of cash flow information is of questionable value.

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: The proposed amendments would require a quantitative disclosure of an entity's available liquid funds, as discussed in paragraphs 825-10-50-23S through 50-23V. Do you foresee any significant operational concerns or constraints in complying with this requirement? If yes, what operational concerns or constraints do you foresee and what would you suggest to alleviate them?**

**Response** - Most information regarding "traditional" liquid assets is already disclosed publicly in regulatory call report or SEC 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.

In addition, with regard to liquidity availability, banks generally 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 proposed approach to disclosures would thus be incomplete in that there are numerous other sources of liquidity not captured in these tables.

***Question 5: For depository institutions, the proposed Update would require a time deposit table that includes the issuances and acquisitions of brokered deposits during the previous four fiscal quarters. Do you foresee any significant operational concerns or constraints in complying with this requirement? If yes, what operational concerns or constraints do you foresee and what would you suggest to alleviate them?***

**Response** – This table presents many concerns as to information an investor needs to assess risk and should be entitled to. 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. We see this as being potentially harmful to the reporting entity. In addition, singling out CDs is questionable in that most of the deposits or other liquidity sources have some inherent cost to acquire. We believe the acquisition cost element is inconsistently applied, inappropriate information and should be eliminated entirely.

***Question 6: As a preparer, do you feel that the proposed amendments would provide sufficient information for users of your financial statements to develop an understanding of your entity’s exposure to liquidity risk? If not, what other information would better achieve this objective?***

**Response** – We believe that managing liquidity risk is a continuum that is not necessarily captured in the ED’s recommended point in time listing of a single scenario set of balance sheet cash flows, and a partial listing of the sources available to a bank for raising cash quickly. 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. We 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. We believe that the proposed disclosures may actually be deficient in capturing the true liquidity positions of financial institutions for reasons outlined above.

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

***Question 13: The interest rate risk disclosures in this proposed Update would require a repricing gap table. Do you foresee any significant operational concerns or constraints in complying with this requirement? If yes, what operational concerns or constraints do you foresee and what would you suggest to alleviate them?***

**Response** – Yes. 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. 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.

Generally, gap schedules have become antiquated as a meaningful tool for estimating and managing interest rate risk for the vast majority of banks primarily as gap reports only reflect 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. 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. We believe that the ED should be modified to allow banks to present their existing gap report with significant methodology assumptions disclosed.

***Question 14: The interest rate risk disclosures in this proposed Update would include a sensitivity analysis of net income and shareholders’ equity. Do you foresee any significant operational concerns or constraints in determining the effect of changes in interest rates on net income and shareholders’ equity? If yes, what operational concerns or constraints do you foresee and what would you suggest to alleviate them?***

**Response** – Yes.

### **Net Income Sensitivity**

With regard to the interest rate sensitivity, the requirements for the preparation of the model mandated in the ED, specifically not incorporating any forward-looking expectations regarding projections about growth rates, asset mix changes, or other internal business strategies are contrary to the current models produced by the Bank and used by management for managing risk. This would not only require us to prepare a completely new set of financial models and projections for eight different interest rate scenarios, but it is also questionable if the mandated calculations will even accurately reflect or present to the reader the true picture of risk related to the Bank's interest rate sensitivity.

We do agree, and currently model, a flat balance sheet in the interest rate sensitivity projections. However, the ED mandate of prohibiting any changes in mix is not only unrealistic, but also necessitates the burden of maintaining a separate "FASB model". We do model earnings sensitivity with a flat balance sheet, we also take into consideration necessary "market realities" including adjusting mortgage prepayment assumptions as required for actual changes; updating reinvestment assumptions for securities given the current investment strategies; assuming excess liquidity would be utilized to pay off maturing borrowings and brokered/national deposits; short-term borrowing maturities being rolled long per ALCO decisions, or vice versa; etc.

We also have concerns as to the FASB proscribed Interest Rate Scenarios which we believe will not necessarily provide consistent information across entities, but merely apply a consistent data point. The required interest rate scenarios and shifts Further, we find it unsettling that the FASB is prescribe the nature and amount of the shock to interest rates that an entity should consider rather than allowing management and the industry to determine best practices for managing balance sheet risk at financial institutions.

Finally, the requirement to disclose a forward-looking 12 month net interest income number in the financial statements is concerning on several levels. Initially, the lack of disclaimers in the footnotes is inconsistent with other guidance requiring significant disclosures of risk factors related to any forward looking projections. Also, disclosing a dollar amount of a projection based on the mandated modeling scenarios in the format proscribed by the FASB, may not accurately reflect the interest rate risk inherent. Any disclosures should be represented as a % change from an undisclosed base case level of earnings assuming no change in interest rates. Additional scenarios, modeling, as determined by management to reflect the bank's risk profile, and discussion of assumptions would be required to more accurately reflect the interest rate risk for the reader to gain a full understanding.

### **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.

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.

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. 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. We fear that financial statement readers may attempt to estimate the value of a financial institution based on the economic value of equity (EVE) disclosures.

***Question 15: As a preparer, do you feel that the proposed amendments would provide sufficient information for users of your financial statements to understand your entity's exposure to interest rate risk? If not, what other information would better achieve this objective?***

**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. Accordingly, our 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.

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.

### **Concluding Comments**

We have numerous concerns with the ED as proposed. 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, we are concerned that the proposed disclosures may have unintended consequences which result in inaccurate and/or inconsistent representations of risk. We are concerned that 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 community banks. We are not convinced that the ED as presented will not be incrementally additive to investors such that the additional operational burden and costs will be justified.

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. Over the last three years the banking regulatory agencies have greatly elevated liquidity and interest rate risk management expectations, 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. We are 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, may be misleading to a financial statement reader, and may be inappropriate to disclose publicly.

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 and in providing documented support for every assumption adequate to be able to meet the requirements of our external auditors to allow them to opine on the tables included in the financial statements of our company..

We have concerns surrounding numerous aspects of the proposed Exposure Draft on liquidity and interest rate risk disclosures. As discussed above, we have severe reservations regarding the potentially misleading nature of the proposed disclosures, the inherent inconsistencies and incomparability between institutions, the significant assumptions involved and limitations in the FASB’s proposed standardized point-in-time disclosures. We respectfully request that the ED be reconsidered and not approved in its current form.

Sincerely,



Blaise B. Bettendorf  
Chief Financial Officer  
First Federal Bank  
First Financial Holdings, Inc.