April 14, 2006

Mr. Lawrence W. Smith
Director
Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1250-001

Dear Mr. Smith:

The staffs of the five federal financial institution regulatory agencies ("the Agencies") are pleased to submit comments on the proposed Statement of Financial Accounting Standards, The Fair Value Option for Financial Assets and Financial Liabilities (the "Fair Value Option") issued by the Financial Accounting Standards Board ("FASB" or "Board").

The Agencies recognize that the FASB has devoted considerable efforts to address issues related to fair value accounting and to try to reduce the existing complexity in accounting standards. We generally support fair value measurement for certain assets, such as traded financial instruments, along with enhanced fair value footnote disclosures. We also support the FASB's efforts to continue its long-term research to carefully evaluate important issues and concerns related to fair value accounting, including reliability of fair value measurements. Pending the completion of such research and issue resolution, we strongly oppose the expanded use of fair value accounting in the primary financial statements for financial assets and liabilities that cannot be reliably measured, such as non-traded, illiquid financial instruments. The Agencies also strongly oppose considering changes in own creditworthiness in the valuation of financial liabilities and in the reporting of earnings related to such liabilities when an entity applies the Fair Value Option.

The Agencies are commenting on several issues listed in the FASB's Notice for Recipients, including those related to reliable measurements and the scope of application for the Fair Value Option (issue 1), the scope exclusion for demand deposit liabilities (issue 3b), the scope exclusion for nonfinancial instruments (issue 5), changes in creditworthiness (issue 6), and
presentation and disclosure requirements (issue 7). In addition, the Agencies are commenting on effective date and transition issues, eligibility criteria, and the balance sheet classification of financial instruments as “trading.”

Our comments on the proposed Standard are presented below.

Scope

Issue 1: Reliable Measurements and the Scope of Application for the Fair Value Option

The Board asked whether there are any financial assets and financial liabilities that an entity should not be permitted to initially and subsequently measure at fair value. In considering this question, we note that the FASB’s Fair Value Measurements Standard, when finalized, should establish a fair value framework that will provide financial statement users a basis for understanding and evaluating the reliability of fair value measurements. We agree with the Board that, conceptually, fair value estimates should reflect the value ascribed by market participants, and not solely by the reporting entity. However, for thinly traded, illiquid financial instruments, estimates derived by an entity based on inputs that are unobservable in the market may not reflect the value a market participant would ascribe and, thus, may be considered unreliable. Indeed, a discussion paper recently prepared by the Canadian Accounting Standards Board, and issued by the International Accounting Standards Board (IASB), suggests that a measurement based on entity-specific inputs is unreliable and should not be considered to be a fair value measurement.¹

Although the Board intends for an entity to use inputs that it would expect a market participant to use, resulting fair value estimates may vary widely and may reflect management’s bias. Interestingly, the Board concluded that when measuring a block of securities at fair value, it would be inappropriate to use a block discount (an adjustment factor for liquidity purposes) because “the methods for measuring the blockage factors (discounts) are largely subjective.”² We believe that fair value estimates based largely on unobservable market inputs will also be largely subjective, may not be independently verifiable, and therefore may be unreliable.

If a fair value estimate for the same instrument would vary widely among reporting entities, such estimates may not be deemed reliable and fair value measurement for such items would be inappropriate. The IASB has provided reliability measurement guidance for certain equity instruments and related derivatives in International Accounting Standard (IAS) 39, Financial Instruments: Recognition and Measurement. Paragraph AG80 of that Standard indicates that measurements are reliable if “(a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.” The Standard prohibits fair value measurements for investments in equity instruments for which no active markets exist and for related equity derivatives if the reliability criteria noted above are not met.

¹ Measurement Basis for Financial Accounting – Measurement on Initial Recognition, a discussion paper prepared by the Canadian Accounting Standards Board, was issued by the IASB in November 2005 for comment.
² Block discounts are addressed in paragraphs C74-C83 of the FASB’s 102105 Working Draft of the proposed Fair Value Measurements Standard.
The Agencies strongly recommend that the Fair Value Option be permitted only for those financial instruments for which a reliable measurement can be made. Furthermore, the Agencies recommend that the FASB develop expanded guidance on reliability that would supplement the concepts contained in the proposed Fair Value Measurements Standard and would clarify how to determine when measurements of financial instruments are reliable. This guidance should take into account the IASB’s criteria for reliable measurements as specified above.

**Issue 3b: Demand Deposits**

The Agencies support the exclusion of financial liabilities for demand deposit accounts from this phase of the Fair Value Option project until further research is performed. This research should address a broad range of measurement issues related to demand deposits. For example, such research should address the appropriateness of including internally generated intangible asset components (such as a core deposit intangible) in the accounting for demand deposits at fair value. Since the price that a market participant would pay for a group of demand deposits would generally include these intangible components, the issue arises as to whether it would be appropriate to recognize these components under an election of fair value for demand deposits, and how such components should be presented on balance sheets.

The Agencies also recommend that the Board clarify that the scope exception would include all financial liabilities with a demand feature, including all savings deposits and other non-maturity deposits. In this regard, in the U.S. time deposits are the only financial institution deposits that have a stated maturity date or required notice period for withdrawal.

**Issue 5: Nonfinancial Instruments**

The Agencies also support the exclusion of nonfinancial instruments from this phase of the project, pending further research and analysis, including whether fair value information is readily available and reliable for nonfinancial instruments.

**Changes in Creditworthiness**

**Issue 6**

The proposed statement would permit an entity to elect the Fair Value Option for certain financial liabilities, including an entity’s own outstanding debt. Under the proposed statement, an issuer who has elected the Fair Value Option for its debt would report changes in the fair value of its debt, including those resulting from changes in the issuer’s creditworthiness, as gains and losses in earnings.

The Agencies strongly oppose the proposed requirement that an entity consider changes in its own creditworthiness in the valuation of financial liabilities that the entity elects to measure at fair value. We agree with the related views about “own creditworthiness” expressed by some Board members in paragraph A11 of the proposed Standard and the alternative view expressed by one Board member in paragraph A26. Allowing an entity to effectively discount the value of
its own debt as the entity's credit condition worsens would have the contrary effect of increasing its net worth at the same time the entity's financial condition is deteriorating. Indeed, under this proposal, a bankrupt firm could appear solvent.

Significant declines in the value of an entity's assets or other adverse business conditions may have a substantial impact on the value of certain of the entity's liabilities, potentially resulting in the reporting of significant earnings under the FASB's approach to the Fair Value Option for financial liabilities. Reporting such gains on an entity's liabilities may be misleading to investors, particularly if the associated declines in asset values are not reported in the financial statements (e.g., declines in franchise values and certain other unrecognized intangibles) or the asset values or adverse events otherwise do not result in the recognition of fair value declines or other losses in the same accounting period in which the gains are recognized. In addition, the entity may be unable to monetize unrealized gains resulting from deterioration in its own creditworthiness. For example, a troubled entity that is not able to liquidate its own debt at less than face value in other than a forced redemption (e.g., filing bankruptcy) would not be able to realize the purported gain. Therefore, current and future period earnings and balance sheet equity capital should not be distorted by recognizing such gains.

The Agencies urge the Board to reconsider its decision to require an entity to include the effect of a change in an entity's own credit standing in the fair value measurement of its financial liabilities.

**Presentation and Disclosure Requirements**

**Issue 7**

Adequate disclosures are critical to provide transparency about an entity's financial and operating condition to investors, shareholders, and other decision-making users of the financial statements. The Agencies believe that the Board should consider including in the final Standard those Fair Value Option-related disclosures required in International Financial Reporting Standards (IFRS) that have not already been included in the Board's proposal for both improved transparency and international convergence.

One example is the disclosure requirement under IFRS related to the effect of changes in an entity's own creditworthiness on the valuation of its liabilities. As noted previously, the Agencies urge the Board to reconsider its decision to require an entity to include the effect of a change in an entity's own credit standing in the fair value measurement of its financial liabilities. However, if the Board decides to proceed with including the effect of a change in an entity's own credit standing as proposed, the disclosures would be critical so that financial statement users are not misled by the counterintuitive effect arising from such valuations. The Agencies believe that the proposed qualitative disclosure of reasons for significant changes in liabilities reported at fair value is insufficient. We believe that the FASB should require quantitative disclosures that separate the change in a liability's fair value attributable to a change in the entity's creditworthiness from a change attributable to other factors, such as a change in market interest rates.
Disclosures about a creditor's loans that are accounted for under the Fair Value Option are also critical in understanding how the creditor is managing its risk exposures. For example, risk disclosures should separately display changes in fair value associated with a creditor's estimate of reduced cash flows relative to borrower-specific credit risk and all other changes in fair value. Borrower performance information such as delinquency status for loans held for investment, when combined with disclosures about credit risk adjustments, would provide useful information to users of financial statements who are accustomed to analyzing delinquency, charge-off, and loss recovery information.

As written, the proposal requires disclosure of the difference between the carrying amount and the principal balance of financial liabilities to which the Fair Value Option has been applied. The Board also should consider disclosure of all contractual amounts owed on financial assets, such as accrued interest and fees receivable.

Additionally, the proposal does not include an appendix with illustrations of the application of the Fair Value Option. Illustrations covering a range of instruments would aid in implementing the required financial statement presentation and disclosures.

**Other Matters**

The Agencies offer the following additional comments related to other matters in the proposed Statement.

**Effective Date**

The Agencies recommend that the Board reconsider the proposed effective date of the Fair Value Option considering its recent decision to delay the effective date of the Fair Value Measurements Standard to January 1, 2008. In this regard, we believe that the Fair Value Measurements Standard should be adopted before, or at the same time that, the Fair Value Option is adopted. This would ensure that there is adequate authoritative guidance that addresses fair value estimates, as well as enhanced disclosures.

If, however, the Board allows adoption of the Fair Value Option Standard prior to adoption of the Fair Value Measurements Standard, we believe that application of the disclosure requirements of the Fair Value Measurements Standard should be encouraged, as applicable, for financial instruments that an entity elects to report at fair value before the entity adopts the Fair Value Measurements Standard.

**Transition**

The proposal would provide an entity an option to report financial instruments currently on its balance sheet at fair value, and any associated adjustments in value would be reported as a cumulative-effect adjustment to retained earnings. This treatment would effectively allow an institution to apply hindsight to its election of the Fair Value Option for individual financial instruments based on whether positions have moved to a gain position since initial recognition.
Such a treatment could invite abuse by allowing an entity to “cherry pick” which existing instruments would increase retained earnings if remeasured at fair value.

The Agencies request that FASB reconsider the breadth of this proposed transition treatment to ensure that the benefits exceed the costs. The Board should consider whether alternative approaches to transition adjustments might be more appropriate. If the Board does provide an entity the option to elect a fair value measurement for existing financial instruments upon adoption of the Fair Value Option, the Agencies suggest that this option be limited to those financial instruments that the entity is already managing on a fair value basis under a documented risk management or investment strategy. Furthermore, the Agencies recommend that the FASB require expanded disclosures related to this transition adjustment, including the entity’s rationale for applying the fair value option to selected instruments and a summary of transition gains or losses by type of instrument.

**Eligibility Criteria**

The IASB included in IAS 39 eligibility criteria for the elective use of the Fair Value Option. For example, IAS 39 requires that the Fair Value Option be used to eliminate, or significantly reduce, an accounting mismatch or be applied to a group of financial assets or liabilities that are managed and reported in accordance with a documented risk management or investment strategy. These conditions were included by the IASB to ensure that the option to elect a fair value measurement for financial instruments is applied only when its use would result in more relevant information.

Given the FASB’s stated objective of international convergence, the Board should reconsider the basis for its decision to exclude eligibility criteria from its Fair Value Option Standard. Regardless of the outcome of such reconsideration, the Board should clearly explain the rationale for its decision in the Basis for Conclusions.

**Balance Sheet Classification of Financial Instruments as “Trading”**

The balance sheet classification for securities that an entity elects to measure under the Fair Value Option, with changes in fair value reported in earnings, is not clearly described in the Standard. Paragraph 10 of the proposed Standard indicates that instruments that an entity elects to report at fair value shall be reported separately on the balance sheet from the carrying amounts of instruments subsequently measured using another measurement attribute. However, paragraph 15 suggests that a reclassification into trading should occur for available-for-sale and held-to-maturity securities that the entity elects to report at fair value upon initial adoption of the Standard.

The Agencies support the requirement in paragraph 10 for separate presentation of instruments measured at fair value under the Fair Value Option to provide transparency about the entity’s asset-liability management strategy and liquidity expectations. However, the Standard should clarify what items should be classified as “trading” to stress that not all items measured at fair value each period, with gains and losses recognized in earnings, should be considered “trading.”

---

3 Eligibility criteria are included in amended paragraphs 9 and 11 of IAS 39.
While commonly thought of in terms of securities, other financial assets and liabilities (such as derivative contracts) are also designated as "trading" under certain circumstances. The Agencies believe that the "trading" categorization should be limited to positions that an entity has determined are being used for trading purposes, and not for longer-term investment holdings of securities or other instruments. Accordingly, the Agencies recommend that the FASB reevaluate the "trading" classification and the criteria for the types of instruments that should be included in that category.

On a related note, the FASB should reconsider the answer to Question 35 of the FASB staff's implementation guidance for Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities, which indicates that any security can be categorized as a trading security at acquisition, even if it is not acquired for trading purposes.

***

The Agencies continue to support the FASB's efforts to improve transparency and disclosures related to financial instruments and appreciate your consideration of the above comments. We would be pleased to discuss our views with you further.

Sincerely,

Charles H. Holm
Associate Director and Chief Accountant
Board of Governors of the Federal Reserve System

Robert F. Storch
Chief Accountant
Federal Deposit Insurance Corporation

Zane D. Blackburn
Chief Accountant
Office of the Comptroller of the Currency

Jeffrey J. Geer
Chief Accountant
Office of Thrift Supervision

David M. Marquis
Director, Office of Examination and Insurance
National Credit Union Administration