
Dear Financial Accounting Standards Board:

We appreciate the opportunity to comment on this Exposure Draft (ED). Our response is written from the perspective of 1st Source Bank, a super community bank serving a defined geographic area with our core banking business. We thank you for your kind consideration of our commentary.

Executive Summary

We have serious concerns with the ED as proposed. The ED requires production of a fixed set of interest rate risk (IRR) measures; this is inconsistent with current industry methods of IRR analysis and contrary to longstanding regulatory precedent that holds any measurement that “makes uniform and simplifying assumptions about the characteristics of a typical bank’s assets and liabilities may be inaccurate for a given institution”. This creates a costly and burdensome reporting requirement, as we will be forced to divert considerable resources from established internal IRR management processes for the sole purpose of providing separate FASB mandated disclosures.

Furthermore, the disclosures prescribed in the ED simply do not accomplish the mission of properly informing financial statement users of an institution’s interest rate risk position, either on a stand-alone basis, or relative to other institutions. 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. Indeed, the imposition of a one size fits all model will ironically create a one size fits none result. Use of standardized reporting templates formulated with no regard to the specific risk profile of the institution in question guarantees that the level of indicated risk will be close to correct only in certain circumstances, and far from correct in others. It is not meaningful or desirable for financial statement users to attempt any comparison of incomplete risk measures. In the case of monitoring the fluid, multidimensional realm of interest rate risk, incomplete information is tantamount to inaccurate information, and it can lead to materially flawed conclusions about true exposures.

We are particularly concerned by the inclusion of a time deposit table that includes the issuance and cost of time deposits originated over the prior year, as it is particularly discriminatory and harmful to community-based institutions that operate within a defined and limited geographic space. While the proprietary business strategy of big, geographically dispersed institutions will be largely obfuscated in these reports, smaller institutions will be forced to expose critical competitive information relating to a primary deposit gathering activity to all competitors within and external to their primary market area. The requirement that our institution expose such information is disturbing, especially since the

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1 Federal Register / Vol. 61, No. 124 / Wednesday, June 26, 1996 / Notices
presentation of such information to the users of financial statements does not provide enough data to draw meaningful conclusions regarding a bank’s true cost of incremental funding. Additionally, several regulatory and accounting schedules already provide balance trend analysis and aggregate deposit cost information.

Most critically, the ED will result in the diversion of crucial resources from the task of measuring, monitoring and reacting to interest rate risk toward the production of the separate FASB-required analysis. We urge the FASB to not underestimate the impact that the diversion of these resources will have in the community banking space – it is simply not logical to divert these resources, especially in an area that our Federal and state regulatory examiners each regularly review in great depth to ensure the institution is operating in a safe and sound manner.

In summary, we are concerned about the substantial cost and reporting burden of the ED, especially in light of the fact that the ultimate usefulness of the added disclosures is questionable. We are even more concerned that the ED greatly underestimates the extent to which the proposed changes will negatively impact financial institutions, who are already working diligently under the reality of greatly elevated regulatory expectations and scrutiny in the areas of liquidity and IRR management. The requirements as presented in the ED have little alignment with current interest rate risk practice, and therefore represent a considerable additive reporting burden that cannot be justified by the incomplete and questionable benefits to financial statement users

Salient Issues

The following section contains a listing of what we consider to be salient issues. We have chosen to selectively cover these items in greater detail to more clearly illustrate our position as presented in the Executive Summary above. These are by no means exhaustive, but we feel they are important for your consideration.

1. We are concerned that the ED greatly underestimates the sheer magnitude of what is required to create a separate set of auditable assumptions to satisfy the requirements of the FASB mandated disclosures. It is important to bear in mind that the final outcomes of the prescribed gap reports and interest rate risk simulations in the ED are extremely sensitive to the assumptions used in creating them.

Our management team is able to arrive at an inherent comfort level with the assumptions used in the current internal IRR modeling based in large part on a uniquely high level of personal familiarity with the Bank, its ongoing operations and its particular risk profile. So, in addition to being able to examine and weigh the empirical evidence supporting these assumptions, management has the added benefit of strong contextual background from which to further assess whether the assumptions are indeed reasonable. It is a difficult and time consuming process to continually produce all of the assumptions necessary to run the current internal IRR modeling. The ongoing timeliness and accuracy of the modeling is dependent in large part on the ability of management to quickly assess the scope and reasonableness of each period’s set of assumptions so that timely production can occur.
As noted in the Executive Summary, the reports prescribed in the ED differ from our internal risk measurement processes. This necessitates creating and maintaining a new and separate set of assumptions to feed the FASB reporting model, since we need to remain free to change the assumptions in our internal modeling as necessary irrespective of what is prescribed by the FASB reporting. In this case, such an endeavor represents more than a just a doubling of effort, as this second set of assumptions will necessitate auditor approval and the assumptions in question are anything but straightforward.

As one example, there is absolutely no accepted universal standard of modeling nonmaturity deposit (NMD) lives, and the range of methods used to model such cash flows results in widely divergent outcomes. More importantly, reasonable differences in NMD decay assumptions can affect whether a bank appears asset sensitive or liability sensitive - a critical distinction. Technically, these deposits have no maturity date and no impediment to withdrawal by the customer. Based upon these two truths, there is no defensible rationale for modeling their lives beyond one day. Yet there is ample empirical evidence that these deposits in fact behave like a long-term source of funding. In reality, forecasting the true behavior of non-maturity deposits is enormously complex, and must incorporate multiple factors ranging from currently observable attrition rates (which can be arguably poor predictors of future attrition levels) to the Bank’s prior history of pricing (which influences the proportion of “rate sensitive” customers attracted by the Bank). And when the analysis is completed, the fact remains that maturities for these funds are still both unknown and unknowable until the funds are removed.

Similar complexities exist throughout the assumptions that would be necessary to support the schedules required by the ED, such as modeling the prepayment characteristics of loans or estimating the pricing spreads of loans and deposits that will be booked in future periods (necessary to properly model runoff replacement in the level-balance sheet interest rate risk simulations prescribed in the ED).

It is a difficult enough task to come up with reasonable assumptions that are acceptable to a management group that is intimately familiar with the institution, its business practices and its competitive market space. The task of creating a second set of assumptions, gathering the sheer volume of supporting schedules necessary to empirically support the rationale for such assumptions, and justifying them to an outside auditor who must opine on the appropriateness of such assumptions is exponentially greater. There are many assumptions in IRR and liquidity risk modeling that are completely reasonable for management to deem as appropriate for internal modeling. Yet these same assumptions have an extremely high burden of proof to be empirically supportable to an auditable standard.

As a final note, it is current practice in the industry to address certain of the “unknowables” that arise in modeling by running multiple analysis scenarios, each with a different but appropriate value for the variable in question, to obtain a better approximation of true sensitivity. At the risk of sounding trite, such effort is necessitated precisely because some things are simply “unknowable”. To arbitrarily select only a single value for such a variable and make any attempt to meaningfully interpret the resulting outcome is illogical. How then, does one sufficiently justify to an auditor a single value for an item that is logically subject to a range of unforeseeable outcomes? And what is the ultimate cost of this ongoing exercise?

2. **Gap reports present an incomplete and often misleading picture of true risk. This does not serve users of financial statements, making it hard to justify the additional effort to produce separate reports.**
It is critical to consider that gap schedules have become antiquated as a meaningful tool for estimating and managing risk for the vast majority of banks, and we do not use gap reports for liquidity or interest rate risk assessment, for they have several pronounced limitations.

Gap reports only reflect cash flow and repricing characteristics for a single rate scenario. Furthermore, gap reports reveal little to nothing about several very real risks, including:

- **Basis risk** - bank products are tied to or influenced by different interest benchmarks.
- **Yield curve twist risk** - bank products are tied to or influenced by interest benchmarks of differing terms
- **Optionality risk** – bank products behave differently under a variety of scenarios

Two bank products scheduled to reprice in a given time period can ultimately experience greatly different relative price changes, the net effect of which may result in added risk to earnings, or no risk whatsoever. Gap reports reveal nothing about the magnitude and direction of potential repricing events. They therefore effectively hide the inherent amount of risk in any repricing mismatch, which is the true issue that needs to be assessed.

Despite various forms of “adjusted” gap reporting that attempt to mitigate such deficiencies, gap reports remain materially flawed. Even if readers of financial statements were provided disclosure on multiple gaps to understand the degree to which cash flow and repricing behaviors may vary under different rate conditions, gap reports would remain an impractical solution. Gap reports are at best incomplete and at worst very misleading indicators of true risk. Furthermore, gap reports are assumption dependent, and any purported comparability of gap reports between institutions that use different sets of assumptions can be extremely misleading, even though each set of assumptions may be discretely justifiable.

We currently prepare internal gap reports. They are configured primarily for accounting reporting purposes. The current ED would require creating and continually updating a separate model from which gap reports would be processed to accommodate specific FASB reporting requirements. Given the aforementioned limitations of these reports as reliable indicators of an entity’s true risk position, the additional cost and re-direction of resources needed to do so seems hard to justify.

3. **We do not manage our IRR or liquidity risk using the particular methods and measurements prescribed in the ED (and are arguably prohibited by our regulatory supervisors from doing so).** Given this fact, we feel the ED may be underestimating the level of supporting “qualitative disclosures” that would be necessary to clarify to statement users on an ongoing basis why we believe the true risk position of the bank may be materially different from that which is indicated in the published disclosures. The ED also underestimates the effect of this ongoing and necessary “corrective narrative” on financial statement users’ perception of the reliability and usefulness of the data presented.

We do not manage our interest rate or liquidity risk based on information gleaned from gap reports due to several material shortcomings as detailed in item number 2 above. Likewise, we do not simulate the effect on our earnings from a yield curve steepening/flattening in only the 0-24 month and over 10 year time periods as mandated by the ED. In our opinion, such rate scenarios are unlikely, or at least no more likely than any of several other arbitrary scenarios. More importantly, we are concerned such scenarios would be insufficient to capture vital
information about sensitivity and risk given the current structure of our portfolio. Regulatory
guidance expressly specifies that “the types of stress scenarios depend on the risk profile of the
institution and the complexity of its structure and activities (emphasis added) 2."

In short, we feel that the nature of the prescribed calculations and the concessions made for the
sake of comparability compromise the calculations to the point where they could often convey an
incorrect perception of risk, either to the positive or to the negative.

The ED calls for additional qualitative disclosures, requiring an entity to provide, “narrative and
additional quantitative disclosures that would enable financial statement users to understand an
entity’s exposure to liquidity and interest rate risks (emphasis added)”.

We are not sure that the measurements prescribed in the ED will necessarily serve as reliable
period-to-period indicators of our institution’s true exposure. If this proves to be the case, we will
be placed in the position of providing an ongoing narrative that begins with the necessary but
awkward task of refuting the implications of the data we just reported, only to replace those
implications with management’s interpretation of what we believe to be the true risk indicated by
our own internal modeling processes. In effect, we could find ourselves in the odd position of
justifying our actions in response to data that we expressly do not use as a basis for our actions in
the first place. Is it not reasonable to assume that such narratives will ultimately adversely
influence financial statement users’ perception of the reliability of the data presented in the
reports?

It is vital to acknowledge that implicitly embedded in the ED is a primary disconnect between the
measures and processes banks actually use to manage their risk position and the measures they
are compelled to report. This is the result of compromises in the ED mandated to enforce
“comparability”. We feel that such compromises could foreseeably lead to incongruities in the
reported data whose effects are much worse than a lack of direct comparability between
institutions. As long as this disconnect continues, significant additional explanatory disclosures
are virtually guaranteed to be necessary, creating a major reporting burden that appears to have
been overlooked in the construction of the ED.

Perhaps more troubling is the fact that, given the stated goals of the ED, such a stark disconnect
exists between the ED and literally decades of regulatory practice. Recent history is littered with
examples of how incomplete or misleading measures of risk have led to grave consequences. Has
the FASB taken sufficient time to consider that the regulatory bodies that have dealt with such
consequences (as they essentially are the ones who “write the checks” to cover the depositors
affected by those events) have for years specifically discouraged one size fits all, cookie cutter
approaches to IRR and liquidity risk measurement because of the danger that these approaches
will lead to inappropriate decisions? Would the regulators not have numerous and compelling
reasons to promote a standardized approach if it were at all an acceptable method of measuring
the risks in question?

We are specifically mandated by our regulatory authorities to “manage IRR exposures using
processes and systems commensurate with earnings and capital levels, complexity, business
models, risk profiles, and the scope of operations” 3. We are simply not free to adopt any external
“one size fits all” risk metrics for purposes of managing our own internal risk, even if we were
inclined to do so. Being an area of heightened regulatory scrutiny, our IRR and liquidity risk

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2 INTERAGENCY ADVISORY ON INTEREST RATE RISK MANAGEMENT - January 6, 2010
3 ibid
management processes will be forced to evolve and adapt quickly to regulatory disposition well into the future. The practical realities of risk management combined with the overriding importance of satisfying regulatory mandate will most certainly continue to widen the already considerable gulf between our current management processes and the mandated reporting. This will not only serve to increase the burden of separate FASB reporting for us, but will also serve to compound the difficulty of presenting any meaningful evidence from the disclosures to statement users.

4. **We believe that the stated goal of comparability as expressed in the ED will not be effectively achieved, and that the attendant sacrifices in measurement efficacy are of greater concern than any lack of supposed comparability.**

We feel there is a very real risk of the following unfavorable outcome. Multiple institutions will each produce their own individual and appropriate set of assumptions governing the timing and behavior of future cash flows. Each set of assumptions will be reasonable and justifiable by some prudent measure. None of the assumption sets will be wrong, per se, but each set of assumptions will of necessity be individually and often materially different. Ultimately, given the inescapable reliance of the simulations on the incorporated assumptions, data that appears to be comparable across institutions will be anything but, as items that appear to be differences in risk exposure are in reality merely the product of assumptions that are discretely justifiable but materially different. Similar to our observation in item 3 above, we do not look forward to being put in a position to defend our published numbers to outside parties who are attempting to use them to assess our relative risk exposure versus that of another institution given the vagaries inherent in such a process.

**Closing**

We are very concerned at how the ED effectively forces institutions to create a dual measurement and reporting system to satisfy the production requirements of the ED, with the attendant on drain on money, manpower and other resources. It is clear that the mandates in the ED do not align with the risk management practices currently in place. It is equally clear that banks are essentially prohibited from replacing their current measures with the mandated measures, effectively “locking in” this dual-reporting structure.

It is critical for all stakeholders that the IRR and liquidity risk analysis functions at banks remain unbiased and unencumbered. No one is served by the adoption of any measure that would in any way dilute the quality of risk analysis at reporting institutions. Risk modeling activities are time-consuming and labor intensive. They require considerable sound human judgment and must harness managerial expertise on a number of levels if they are to be truly effective in their stated task. These areas are a particular focus of the primary regulatory agencies in the banking sphere. Financial institutions must be free to pursue whatever strategies are reasonable and prudent to both bank management and bank examiners. For community banks, which make up the vast majority of the banking universe in the United States, any diversion of resources in the realm of specific FASB reporting equates to lost effort in the realm of measurement and control.

We further offer that the ED completely ignores the vast quantities of quality indicative data produced by internal reporting mechanisms for the sake of the false security of comparability. Each financial institution is required to create and maintain customized risk measures that are appropriate to its individual and ever-changing risk profile. The ultimate propriety of these measures is approved on an ongoing basis through regulatory examination. Any meaningful communication of the risk position of an institution must be based on an appropriate presentation of this information by bank
management, in a format that is flexible enough so the truly pertinent data in each case can be provided for users of financial statements. Such an approach is in greater agreement with years of industry and regulatory field experience, and represents the best defense against the very real consequences of reliance on inappropriate measures of IRR and liquidity risk.

Sincerely,

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