2012-200
Comment Letter No. 20

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Technical Director
File Reference No. 2012-200
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:

The Savings Bank is a $450 million state-chartered, mutual bank headquartered in Wakefield, Massachusetts. Our charter dates to 1869. We have eight full-service branches.

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. Accordingly, our 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.

Executive Summary

We have numerous concerns with the ED as proposed. While we explain our specific issues below in more detail, the general nature of our 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.) including The Savings Bank.

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. *We are concerned about both the cost and the usefulness of the added disclosures.*

We are 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.

We are quite comfortable with these general assertions. The remainder of this letter outlines some of these issues and then answers specific questions asked to be addressed by the ED.

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 our Board of Trustees. 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 – in our case, The Darling Consulting Group. 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. This, in our case, is both the Federal Deposit Insurance Corporation and the Massachusetts Division of Banks.

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. 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, is misleading to a financial statement reader, and/or is inappropriate in our 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.

Most core systems do not track maturity or re-pricing 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
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, in some cases based on historical experience.

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? We 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).

This also raises an important issue relating to the concept of deposit decay: there is absolutely no industry standard for this exercise. 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?

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.

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.

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, in our case the Federal Home Loan Bank of Boston.

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. We see this as being potentially harmful to the reporting entity.

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 The Savings Bank, CD balances have been declining substantially during this current economic cycle, both by design and by customer preference.

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. And, again, The Savings Bank (like hundreds of smaller institutions in Massachusetts) is a MUTUAL bank.

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.

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 re-pricing 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 "re-pricing 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 re-pricing dates should

be presented in the aggregate in the total carrying amount column (i.e. excluded from the body of the re-pricing buckets).

This raises a question as to the intention of FASB regarding the presentation of re-pricing 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 re-priced anytime? Since DDA has no re-pricing 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 "re-pricing date" definition.

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 re-pricing characteristics for a single interest rate scenario. Therefore, readers of financial statements would need disclosure on multiple re-pricing gaps to understand the degree to which cash flow and re-pricing 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.

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.*

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". We believe that it will only provide one consistent set of *data* elements across entities as opposed to consistent *information.*

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 re-pricing 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. 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.

Forward Looking Earnings
We 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?

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.

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 re-pricing 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 re-pricing / 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 re-pricing 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.

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

Response – No. We believe the re-pricing gap offers little to no value in helping users of financial statements understand and assess interest rate risk.

Question 17 – Are the proposed time intervals in the re-pricing 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 re-pricing gap analysis in paragraphs 825-10-50-23Y through 50-23AC provide decision-useful information in the analysis of financial institutions. We do not.

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 - 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.

Concluding Comment

We are 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 and we have reservations regarding the misleading nature of the proposed disclosures.

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

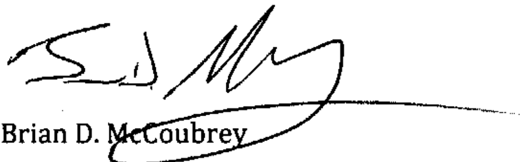
> In an effort to create consistency, the ED mandates a reduction in subjectivity surrounding the calculation of estimated risk for a financial institution.
>
> Given that any risk measurement system requires meaningful assumptions and subjectivity, the reduction of subjectivity by FASB increases the 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.

Thank you for taking the time to read our comments.

Sincerely,



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