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September 28, 2010

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
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Norwalk, CT 06856-5116

File Reference: No. 1810-100 Accounting for Financial Instruments and Revisions to Accounting for Derivative Instruments and Hedging Activities

Dear Mr. Golden,

Darling Consulting Group, Inc. (an asset/liability management advisory firm assisting over 400 banking institutions throughout the United States) and the attached 191 co-signing institutions appreciate the opportunity to comment on this Exposure Draft (ED), which is likely the most significant and impactful proposal issued in FASB's history.

We applaud FASB for seeking ways to improve what has become an enormous but in many aspects, an unnecessary exercise in the accounting/reporting for derivatives and related hedging activities (Topic 815).

However, we strongly oppose Topic 825 (Financial Instruments) and its proposed quantum leap towards a full fair value accounting world. We have a long standing and documented history of opposing the application of fair market value accounting to the banking industry because of its highly probable adverse consequences.

While we summarize our logic and concerns throughout this letter, the basic tenet of our deep rooted opinion is actually quite simple: *the purpose of accounting is to reflect, not determine, how a business is conducted.* Given that the banking industry will be impacted by this ED far more greatly than any other industry, it is important to remind FASB that a fair value accounting model is inherently inconsistent with the highly typical banking business model.

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Accordingly, if this Proposed Accounting Standard Update is allowed to prevail, then so too will the Law of Unintended Consequences prevail with potentially far reaching implications, including:

- Reduced competitiveness of US Banks vs. Foreign Banks,
- Increased cost and reduced availability of capital to banking industry (especially "community banks"),
- Decreased availability of credit, and a slower growth rate of US economic activity,
- Materially curtailed access to long-term fixed rate funding by US households and businesses,
- Reduced comparability and increased complexity of financial reporting by the banking industry; thus, reduced transparency,
- False signaling and undesirable volatility in reported bank capital levels (and earnings), especially during times of economic stress, and
- Elevated probabilities for bank failures impacted inordinately by accounting rules vs. economic/business fundamentals.

We urge FASB not to dismiss these concerns as mere emotional "scare tactics," but rather to recognize that they, and others discussed below, are very real potential outcomes of the Law of Unintended Consequences. *In this regard we also remind FASB of Albert Einstein who quite astutely observed that "In theory, theory and practice are the same. In practice, they are not."*

Banking Business Model vs. Fair Value Accounting Model

Fair Value Accounting (FVA) concepts are not appropriate for financial intermediaries such as the great majority of commercial banks, savings banks and credit unions. Most financial intermediaries generate the bulk of their earnings from the spread they earn between the income on assets and the costs of their liabilities; the preponderance of which are held to maturity/withdrawal (i.e. for extended periods of time). Very little earnings for these financial intermediaries results from the sale of assets and liabilities. FVA measurements neither reflect how earnings are created nor capture the true going concern value of this type of financial institution (again, which constitutes the vast majority of banks).

For those banks with elements of their business models that are more trading or fair value oriented, current accounting guidance (e.g. FAS 157 / 159) adequately allows for the representative accounting for and reporting of these business activities.

To impose a market value concept, that by definition presumes the existence of liquid markets, on business entities that operate primarily in a world of illiquid markets is suspect at best and dangerous at worst. The operating results of the community bank business model, based upon managing spread as opposed to price changes, is not captured accurately by a fair value accounting model.

Accordingly, and since we also consider ourselves users of financial reports, this letter intentionally avoids addressing the specific 49 of the 55 applicable questions FASB has set forth regarding Topic 825. We question the utility of responding to these inquiries individually when we believe that FASB should more carefully weigh the higher level negative impact of this proposal on the users of financial statements, the banking industry and the economy as a whole before "finalizing" the technicalities of what we believe is a highly flawed accounting approach.

Notwithstanding, we do comment below on a few of the items.

Fair Value's Fragile Assumptions: The Credit Component

Fair value accounting is based on a current snap shot of the perceived values of the financial instruments that comprise a period ending balance sheet. Valuations must be based upon the combination of past events and existing conditions. Future events cannot be forecasted. Therefore, sound logic and financial realities such as "our Bank's capital, earnings and liquidity positions are such that it will not need to sell assets into the current illiquid marketplace, and therefore will not realize the corresponding discounted prices that forced sellers experience" are deemed irrelevant.

Accordingly, and regardless of a given bank's relative financial strength, fair value accounting extrapolated to the entire loan portfolio presents a very clear and present danger; one that further penalizes otherwise well managed banks that happen to operate in more relatively stressed economic areas saddled with onerous local valuations.

Even the best performing bank portfolios would be subjected to sizeable discounts during periods of general economic duress. In the current environment performing commercial real estate portfolios have been saddled with 10-15% discounts that escalate further in the more problem market areas ("guilty by association"). The reality is that if all bank loans were subjected to the implied valuation litmus test that is being proposed, then the likelihood of any lending-oriented bank (especially if commercial) left standing would be minimal at best. This effect would be amplified at smaller community banks whose loans, due to size and local nature, are "less marketable" than those of its larger counterparts.

To conclude that this is reflective of "reality", and therefore should be captured in earnings and capital, would be difficult to comprehend. To conclude that this is reflective of the fact that the vast majority of banking institutions operate with "illiquid" balance sheets (e.g. local market loans and deposits that cannot be freely traded), and that if forced to liquidate could not do so without incurring unrealistic and unnecessary discounts (not representative of the intrinsic values of the underlying cash flows), and that such across the board discounts cannot possibly be supported by regulatory capital levels, *would be* an accurate statement.

Also, loan fair values implicitly assume 1) current market factors (interest rates, market liquidity, credit spreads, etc.) that drive the fair value equation are "static," and 2) reported values from the perspective of a financial reader are reflective of a "fair" value that will flow through the future earnings performance of the reporting bank. Both implied assumptions are highly questionable.

In this regard the disparity of underwriting cultures among financial institutions cannot be overemphasized. This variable adds a tremendous amount of "judgment" to calculating fair value, as well as murkiness regarding the ability to compare "fair values" of different banks. There will be no clarity, by definition.

In theory, FASB can talk about a reporting entity "using its judgment" on certain matters. In reality, many are finding that it is not the "judgment" of those that sign the financial statements that really matters.

In practice, it too often appears that the only opinion or "judgment" that matters is that of the CPA firm (or regulators); an opinion which we often find is not "free from bias." Candidly, what we hear from bankers is too frequently reflective of what seems to be third party biases towards a more self-serving and often draconian view based more on the covering of their flank than on fair and accurate reporting of the bank's financial position. The following serves as a real life example of what life in a "fair value world" might very well look like:

- A multi-billion dollar bank was "forced" to lower their reported "fair values" on their FAS 107 footnote disclosures for their performing loan portfolio to a level that was 7-10 points lower than the bank estimated amounts. The only opinion that "mattered" was that of the CPA firm that "felt" the loans were worth less. They had a "price in mind" that they were comfortable with; one that had nothing to do with the particular bank portfolio in question, but rather based upon some "studies" they had done relating to prior credit cycles and the current market. Fair reporting? For many banks, the risk of such credit related exit pricing disclosures on performing loans will be to signal *incorrectly* that they are technically insolvent, or rapidly headed in that direction.

And, No More Allowance For Future Loan Losses? It is no wonder that the regulatory community is strongly opposed to a proposal that basically eliminates any meaningful counter cyclical loan loss provisioning for an industry so critical to our country's financial backbone. To argue that safety and soundness is solely a regulatory issue seems a bit disingenuous from our perspective, especially since CPA firms explicitly comment on whether the company they have attested to is deemed a going concern.

Fair Value: Forcing a Narrow Short-Term Focus

Currently, financial institutions provide guidance on the fair value of their balance sheet to the market and users of financial statements at least annually through the disclosure requirements of FAS107. Publicly traded companies are compelled by the SEC to augment that information with an assessment of interest rate risk and how the balance sheet will perform if rates rise and fall. Current FASB guidance requires ample footnote disclosure regarding asset quality and balance sheet valuation, which we view as sufficient.

A question we asked ourselves: "What is accomplished by bringing this information on balance sheet via the profit loss statement or through other comprehensive income (OCI)?"

The reasoning has to be substantial, as this requirement will change the entire approach banks take in regards to lending and cause a tsunami like ripple effect through the financial system.

To provide a frame of reference, a 1% shift in rates could drive at least a 5 point swing in the value of a 30 year mortgage. Banks would need to "reserve" (keep capital idle) against such risks, even though rates could change the very next month, reversing the "write down" and even producing "a gain." This yo-yo effect would have been prevalent throughout the past year; thereby providing continually changing and mixed signals to the marketplace despite the fact that cash flow earnings of spread-driven banks were impacted negligibly during the roller coaster ride of "fair values."

Furthermore, recent history has witnessed a tremendous drop in interest rates that has glaringly changed market values of financial instruments. With rates at historical lows, one can only assume that they will rise at some point in the future. Regardless of a Bank's interest rate risk profile, longer-term lending (residential and commercial) as we know it will cease to exist. The same will apply to corporations and municipalities looking to lock in their long-term financing costs in the bond markets. The reason is the capital requirement to cover valuation "hiccups" will be substantial for those banks that traditionally support longer-term borrowings and bond issuances. Accordingly, accounting risk may very well supplant credit risk as the primary factor in structuring loans.

The only vehicle available for fixing funding costs will be the interest rate swap markets (derivatives), markets that many community banks shy away from due to current accounting complexities and the inconsistent manner in which such accounting has been applied since the issuance of FAS 133.

A migration to a short-term financial instrument focus will also occur for another fundamental reason. Banks cannot manage total balance sheet volatility resulting from financial instrument valuation changes by simply picking up the phone and trading pieces of their balance sheets. They operate primarily in illiquid markets that do not enable them to buy and sell loans and deposits at will. Again, to force an accounting model that presumes the existence of liquid markets on businesses that conduct their business primarily in illiquid markets has little, if any, upside; and a tremendous amount of downside.

This begs the obvious question noted above, that we have answered in our own minds: Little benefit is achieved relative to the potentially destructive outcomes of the ED as currently proposed.

Fair Value: "Remeasuring" the Value of Core Deposits

While much of our argument against the concepts of this ED center on loans and lending practices, we feel that accounting for certain liabilities at fair value can be equally confusing and misleading to financial statement readers. This is especially the case relating to the proposed "remeasurement" (clearly reflective of a reluctance to use the words "fair" or "value") of core deposit liabilities.

Over the years our Company has prepared thousands upon thousands of valuation calculations for interest rate risk measurement and reporting, as well as for core deposit valuations. Irrefutably, the single biggest impact on the results of these total balance sheet value calculations (e.g. EVE – Economic Value of Equity) resides within the estimated values for core deposits. And core deposit valuations are the most assumption dependent of all financial instruments on a Bank's balance sheet (excluding the impact of credit risk on loans, which is not applicable in this context). While the issues are many, the following should be a sufficient sampling of why the "remeasuring" of core deposit values is, plainly and simply, a flawed concept with more unintended consequences than meets the eye:

- Given a 300-400bp change in market interest rates, the proposed "remeasurement" can readily produce a 375bp-500bp increases/decrease in GAAP capital ratios (excluding any potential impact of taxes). Core deposit values are inversely related to interest rate levels, with non-maturity deposits providing a greater benefit when replacement costs of funds are high. Prior to the current economic cycle core deposit valuation calculations were commonly producing 15-20% premiums (and even higher, depending upon "assumptions"). As interest rates have fallen, core deposit values have declined substantially. Imagine what incremental impact this would have had on public perceptions of the banking industry if these kinds of incremental reductions in capital ratios (and earnings) were being reported. In fact, the strong bond market rally during these 2010 summer months has had a marked downward impact on core deposit valuations, just as the credit adjustments have seemed to slow;

- Banks can report declining capital (and earnings) because 1) customers migrate into transaction accounts for safety or because of low alternative investment yields, and/or 2) the Bank was successful in attracting core deposits from other banks. An unintended consequence of the proposed measurement is that low interest rate environments (such as the one we are now experiencing) can produce negative values for incremental growth of core deposits. This is enabled by the discounting methodology that can produce a discount factor less than "1" (all in cost to service deposits is greater than the alternative funds rate). We have seen this occurrence in recent "valuation" calculations for interest rate risk measurements;

- Depending on methodology, core deposit life estimates can vary greatly. We have seen ranges from 1.5 years to 10+ years, for example, on bank demand deposit bases. And the estimates can vary greatly when comparing regulatory perspectives (such as those embedded in calculations presently performed by the Office of Thrift Supervision and previously proposed by the FDIC/OCC) to the estimates prepared by third parties. The margin for error, and the related impact on reported values, can be quite material;

- The "Alternative Funds Rate" is an illusion when combined with the constraint that the sources "be sufficient in volume and duration" to replace the core deposit liabilities. First, most community banks have policies limiting their use of these funds to aggregate levels less than their total level of core deposits. Second, many banks are limited by the providers of such funds (e.g. Federal Home Loan Bank, Brokered CD markets), or by their bank regulators, from further accessing these alternative funds; and

- The ED seems to imply the ready existence/availability of "peer data," *and* the related presumption that the corresponding data is reflective of an accepted "industry standard." We are not aware of this being the case, and we are quite familiar with this subject matter. If FASB's due diligence on this critical matter has identified the existence of such widely recognized and accepted industry standard data, we would welcome the insight.

Sharing numerous other issues would add nothing additional to our contention that the proposed remeasurement of core deposits would produce material unwarranted volatility and non-comparability into bank financial reporting, not to mention the introduction of information with a high potential to provide both false positive and false negative signals regarding financial strength or weakness.

Implementation Costs

The upfront and ongoing operational costs required to comply with the proposed guidance are mind numbing. These costs transcend the obvious direct costs of implementation and include material opportunity costs to the industry.

The direct costs of implementing the requirements of this ED will be substantial as significant modifications and additions will be required for many bank systems including application systems for loans and deposits, product and customer profitability, credit underwriting and administration, general accounting and financial reporting, management and board reporting, and others. Additionally, internal training requirements will permeate the organization, including at the Board level; a phenomenon that can only stress the related oversight capacities for performance, security, risk management, etc.

Given these and other related issues, the costs of examinations, internal audits, and financial audits will undoubtedly increase commensurately.

Opportunity costs will also be prevalent, with the most notable being the additional burdens placed on management time. This will take much needed and valuable time away from focusing on nurturing and growing their businesses when banks are already severely distracted by the pressures emanating from the current economic and regulatory environments.

Also, the accounting profession has a questionable track record in dealing with the implementation of previous accounting standards/pronouncements relating to fair value accounting theory. The approach of basically letting things play themselves out in the field has been very problematic, and for numerous banks, quite damaging. The high degree of subjectivity embedded throughout the ED, along with the numerous questions FASB itself has posed for comment, seems to indicate that the proposed standards will also be played out in a similar manner. The stakes are much too high for such implementation philosophies to be allowed to continue.

Finally on this subject matter, the law of unintended consequences can create additional costs directly related to the implementation of accounting changes. Perhaps the best example relates to FAS 133 and the impact it had on the accounting for plain vanilla derivatives (interest rate swaps, floors, and caps) that were commonly used to hedge interest rate risk. What FASB was warned about came clearly to pass as community banks virtually “shut down” their previous use of these risk management tools due to

confusion, complexities, and "accounting horror stories" that evolved post FAS 133 (resulting from accounting technicalities rather than the merits of derivates use). For those banks who refused to let the accounting get in the way of the economics, we have witnessed too many of them expend undue monetary and human resources complying with these rules, often having to deal with outcomes that lack materiality and/or common sense.

If this same level of technical "precision" is expected to be applied to the rest of the balance sheet and on instruments that lack true secondary markets, the cost of defending assumption based values will cripple the industry.

Fair Value: Who Wants This, and Why?

Despite our efforts to identify the important critical mass that presumably has voiced representative support of FASB's push for fair value accounting, we continue to come up short in answering the above questions.

Bankers certainly are on record as being against this proposal due to the fact that the business model will have to change to accommodate the accounting model. This proposal, by bringing fair value on balance sheet, will materially "change the rules of the game" rather than provide a "better scoring system for tracking the game."

Bank regulators oppose it, as the pro-cyclical and near term focus of the accounting model will add undue risk to the financial system.

While the political sector has been mostly silent, we believe it will be awakened as the implications are more clearly understood. This accounting proposal will not only result in more market volatility, it will also result in reduced availability of term credit, and we think the availability of credit in general.

And most importantly, the primary users of financial statements in the investment community have publicly stated that they feel the proposed guidance is not appropriate or cost justified.

While hedge funds and mutual funds have expressed support, their business models are the antithesis of banks. In fact, that hedge funds (lovers of volatility) are supportive should make FASB suspect.

Aside from FASB, businesses with daily claims/trades on their net asset values, and investors with short sale interests, we have yet to find any clear support for the proposal.

Closing

While fair value information may have some utility to an investor reviewing financial statements, this information is currently available in footnotes, where we feel it belongs.

To focus on the nuances of the ED is premature, since the real issue resides in the merits of the proposed fair value oriented accounting model in general. As stated in the beginning of this letter, *the purpose of accounting is to reflect, not determine, how a business is conducted*. The Proposed Accounting Standards Update, specifically Financial Instruments Topic 825, will undoubtedly modify bank management behavior based solely on reactions to accounting rules rather than in response to meaningful economic, business and customer stimuli. Accordingly, the issue of implementation cost (while quite substantial) is moot.

The Law of Unintended Consequences cannot be ignored or assumed away. The reality is that the vast majority of investors in and the providers of capital to the banking industry do not like volatility or surprises. The ED will fail on both accounts, leading to uncertainty.

Uncertainty and volatility will likely reduce the availability of capital to the industry, and absolutely increase the cost of whatever capital is available. Consumers and businesses will also underwrite the costs of fair value accounting as they discover that access to credit is curtailed and the terms of credit less flexible/favorable (including lack of availability of fixed rate credit, and higher credit spreads). The increased capital levels (already more onerous than for Foreign Banks) that will be required to support accounting uncertainty will result in less capacity for banks to lend, which when combined with tightened credit standards (to avoid credit related accounting surprises), will reduce the velocity of money flows and negatively impact the growth capacity of the US economy. Think we're "alarmists?" Please, think again.

Remember the words of Albert Einstein that *"In theory, theory and practice are the same. In practice, they are not."* While we doubt anyone would argue the existence of "Accounting Nirvana," we do believe that it is quite possible for the existence of "Accounting Hades."

Accordingly, we feel the FASB should abandon this exposure draft, scale back the use of fair value measurement when accounting for assets generally not held for trading, and continue to explore ways to simplify the accounting for derivatives.

We thank you for your time in reading our comments, and appreciate your serious consideration of our thoughts and recommendations. We would be happy to discuss this letter with you.

Sincerely,

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(and attached co-signers)

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