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September 1, 2010

Russell Golden  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

File Reference Number 1810-100

Dear Mr. Golden:

The Independent Community Bankers of America<sup>1</sup> (ICBA) welcomes the opportunity to comment on the Financial Accounting Standards Board's Exposure Draft: *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. The following contains our views on the Exposure Draft to date, but we are receiving comments on it from community banks daily and plan to share additional comments with FASB by the September 30 comment period deadline.

**ICBA urges FASB to withdraw the proposal and not go forward with the accounting changes contained in the Exposure Draft. In our view, the accounting that would result if this proposal went forward would greatly misrepresent the operations of community banks and many other financial institutions whose primary business practice is to hold financial instruments to collect contractual cash flows, not to trade them on a regular basis.**

Community banks fund their operations by taking deposits and holding loans for the long term. Most financial instruments community banks hold are not readily marketable. Community banks are not in the business to create or purchase assets or liabilities for quick resale. If the proposed accounting treatment goes forward, community banks will have to reconsider making longer-term loans and deposits because of the impact of the changes in fair values they will need to record. This will hurt community banks and other financial institutions that hold these instruments, but

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<sup>1</sup> *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

*With nearly 5,000 members, representing more than 20,000 locations nationwide and employing over 300,000 Americans, ICBA members hold \$1 trillion in assets, \$800 billion in deposits, and \$700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at [www.icba.org](http://www.icba.org).*

more importantly it will hurt consumers and small businesses who now depend on the greater certainty that longer-term deposits and loans offer. We do not believe that it is the role of accounting to drive financial product offerings or limit financial choices.

Community banks tell ICBA that their investors also do not support this proposal, be they local members of the bank's community who own shares of the bank or professional analysts who focus on the financial services industry, particularly publicly traded companies. Investors that community banks have been discussing this proposal with do not see it as an improvement in transparency. Community banks, along with other financial institutions will need to expend significant resources to comply with this standard that is of questionable value. Current accounting and reporting systems are not currently designed to implement the proposed changes. Compliance will require adding additional staff, making significant system changes and in many cases hiring outside consultants to provide valuation assistance. Banks will expend significant amounts of funds to implement and comply with the accounting treatment, funds that would be better used to provide needed credit to their communities.

While the intent of the proposal is to provide better transparency and comparability of financial statements, the fair value measurements on which it is based depend on many subjective assumptions. As a result, it will not achieve its goals. One larger publicly traded bank told ICBA that the proposed accounting changes would greatly advantage bank insiders to the detriment of outside shareholders because the financial information presented to the public as a result of the accounting changes would not reflect the true financial condition of the institution; only insiders would know its true condition.

Accounting standards and guidance should not be pro-cyclical. Recent market conditions have demonstrated the pro-cyclical nature of mark-to-market accounting as declining values of financial instruments necessitated write-downs and sales, causing further write-downs and sales. We believe that the proposed accounting changes will exacerbate cyclicity in financial results due to the greater reliance on fair value measurements, valuations that will be less accurate than current accounting requirements.

### **Background**

The proposal would require (1) presentation of both amortized cost and fair value on an entity's statement of financial position for most financial instruments held for collection or payment of contractual cash flows and (2) the inclusion of both amortized cost and fair value information for these instruments in determining net income and comprehensive income. It would also require that financial instruments held for sale or settlement (primarily derivatives and trading financial instruments) be recognized and measured at fair value with all changes in fair value recognized in net income. FASB states that by presenting both amortized cost and fair value information on the financial statements, the amortized cost would provide information about management's expectations about the instrument's contractual cash flows, the fair value would provide the best available information about the market's assessment of the risk that the cash flows will occur.

Financial Instruments required to be classified using fair value with changes reflected in net income include: trading instruments, derivatives, equity securities and hybrid instruments containing embedded derivatives that would otherwise require bifurcation and separate accounting.

Financial Instruments (e.g. loans, debt securities, certain beneficial interests) would be measured at fair value with certain changes in fair value recognized in other comprehensive income if:

a. It is a debt instrument with a principal amount that will be returned at maturity or other settlement (the instrument cannot be contractually prepaid such that the holder would not recover substantially all of its recorded investment).

b. The entity's business strategy is to hold these debt instruments for collection or payment of contractual cash flows rather than to sell or settle with a third party (based on how the financial instruments are managed as a group rather than the intent for an individual financial instrument; the entity must demonstrate it holds instruments for a significant portion of their contractual terms).

Instruments measured at fair value with changes reflected in other comprehensive income will be subject to a credit impairment model.

### **Core Deposits**

The Exposure Draft calls for a present value measurement approach for core deposit liabilities. Core deposits would be re-measured each period using a present value method that reflects the economic benefit ("intangible") that an entity receives from this lower cost, stable funding source. Deposits would be discounted at the rate differential between the rate charged for the next best alternative source of funding and the all-in-cost-to-service rate over the implied maturity. Thus, under the proposed model that creates "current" value information, the effects of changes in market interest rates would be transparent on core deposits and other financial liabilities and the financial assets they fund.

ICBA opposes the proposed change in accounting treatment for core deposits. We have concerns about considering alternative funding sources to determine core deposit valuations. While this may work for larger financial institutions that are active in the capital markets for various funding alternatives, many smaller community banks have limited alternative funding sources, particularly if they are located in small rural communities. As of June 30, 2010, the average loan to deposit ratio of banks with less than \$1 billion in assets was 93.4%. Community banks price their deposits to maintain them and as a result the rates are quite stable. Yet a funding alternative such as Federal Home Loan Bank advances will be priced by the capital markets and may behave quite differently than core deposits. Thus, for many community banks the proposed "current" value calculation would not provide accurate information. The calculations will also be expensive and time consuming, particularly for smaller banks that have limited staff resources to conduct the analysis.

We also have concerns about attempting to quantify the economic benefit or "intangible" that an entity receives from core deposits. These benefits may be unique to the institution that holds them. It would be impossible to determine the intangible benefit of providing a slightly higher interest rate to municipal deposits so the school tax dollars get recycled within the bank's own community. Similarly, how does a bank value the "intangible" benefit of offering sweep accounts to local businesses which provide employment and economic stimulus to its own community? Those same dollars could go anywhere in the world and the loss to the local bank would go beyond the cost of alternative funds.

Demand deposits that are not considered core demand deposits would be valued at fair value. FASB believes fair value is reasonably close to face amount because of the short-term nature of these deposit liabilities. Since FASB recognized that the values are reasonably close, why force financial institutions to expend the resources to determine a fair value that is not that different from face value? ICBA opposes requiring institutions to record demand deposits at fair value.

Fair value does not include the value of relationships. For example, a deposit account may pay higher interest or a loan may carry a lower rate so that bank may retain an extremely important relationship which is very profitable overall. Some community banks have pointed out that if they are forced to utilize some nationally based assumptions, new loans may be booked at a discount, creating a loss on day one. Calculating a market value based on a nationwide constant, such as an interest rate or term may be very misleading to financial statement users.

### **Liabilities**

In our view it is very misleading to reflect changes in an entity's own credit risk in the measurement of a financial liability, recognizing a gain from a decrease in its own credit risk and a loss for an increase in its own credit risk. Companies cannot often realize a gain in the liability and it is misleading to financial statement users to suggest that it can.

### **Loans**

ICBA also opposes requiring fair value calculations for loans that are held for the long-term to collect cash flows. Community banks hold many loans that do not have a ready market, and would require Level 3 measurements, such as small business loans and agricultural loans. These loans are typically designed to meet a particular customer's needs, and do not have the uniform characteristics that would facilitate determining fair values for them. We question how fair value measurements will provide a better understanding of illiquid agricultural loans held by a small bank in a rural area. Also, community banks have often had difficulty selling rural residential mortgages to Fannie Mae and Freddie Mac because the properties do not fit established secondary market standards. As a result community banks make the loans and hold them in portfolio until they are repaid or mature. Again, establishing fair values for the types of loans held by many community banks would be costly and result in data of questionable reliability. Assumptions that a bank in one community may use would differ significantly from those appropriate for another, making it difficult to ensure comparable data.

### **Credit Impairments**

According to the Exposure Draft, there would be a single credit impairment model for all financial instruments that are measured at fair value with changes recorded in other comprehensive income, and short-term receivables measured at amortized cost. FASB proposes to remove the current incurred loss "probable" threshold for recognizing impairments on loans and proposes a common approach to providing for credit losses on loans and debt instruments. Instruments would be evaluated for credit impairment at the end of each reporting period; credit impairments would be recognized in net income when the entity does not expect to collect either all contractual amounts due for originated financial assets or all originally expected amounts to be collected for purchased financial assets. Interest income would be recognized after considering cash flows that are not expected to be collected. There would be a prohibition on forecasting future events or changes in economic conditions. FASB believes that this accounting treatment

should better reflect a financial instrument's interest yield and credit losses will be recognized earlier.

ICBA is continuing to discuss how best to treat credit impairments and address loan loss reserves with its members. However, we find areas of the proposed guidance confusing in that it prohibits the use of future events and conditions yet states that in assessing factors that shall be considered when evaluating whether a credit impairment exists an entity shall consider relevant available published data such as industry analyst and regulatory reports and sector rate credit ratings. Such reports often contain forecasts or comments on future events or conditions.

Career bankers have experienced economic cycles, whether their banks are agriculturally focused, operate in the oil patch, a mining area or other area that is not immune to down turns. Current standards and guidance for the setting of the allowance for loan and lease losses give financial institutions little ability to set aside reserves in good times to prepare for bad times, lest they be seen as managing earnings. Yet, conservative community bankers (and bank regulators) see the need for more flexibility in this regard, as they are well aware of economic cycles and the difficulties of absorbing losses and raising capital during times of economic difficulties, such as the current environment. The difficulties our economy is currently facing underscores the need to provide some flexibility to prepare for economic changes going forward. Also, it is troubling that some financial institutions are finding that current accounting standards are forcing them to decrease their allowances at a time when they know more problems may be on the horizon. Such an allowance change may well be misleading the users of their financial statements.

### **Comprehensive Income**

FASB is calling for a new continuous statement of comprehensive income to enhance the prominence of the items reported as other comprehensive income. Other comprehensive income would be presented below net income and for items where changes in fair value go through other comprehensive income, both cost and fair value would be presented. Other comprehensive income would not be reflected in earnings per share, but total comprehensive income would be provided when earnings are released. Community bankers are in agreement that the expanded reporting of comprehensive income is unnecessary and of little use to most financial statement users.

### **Delayed Compliance for Non Public Companies**

FASB has not proposed the implementation date for the changes. However, nonpublic entities with less than \$1 billion in total assets would be given an additional four years to implement the new requirements relating to loans, loan commitments and core deposit liabilities that meet certain criteria. FASB believes that such a deferral would allow these entities to develop and refine the capabilities and processes necessary for valuing loans, loan commitments, and core deposit liabilities before being required to recognize these amounts on the face their its financial statements and allow FASB to perform a post-implementation review of the new requirements two or three years after the initial effective date. It is our understanding that this deferral will apply to over 90 percent of the banks and credit unions in the country. While additional time is clearly needed, it underscores the complexity and magnitude of the changes. We agree with FASB members Leslie Seidman and Lawrence Smith that the need for such a deferral calls into question whether the basic classification and measurement model of the proposed guidance would meet a cost-benefit test.

While we appreciate FASB recognition that non public companies may need significantly more time to prepare for the implementation of the changes, a number of community banks we discussed this with told us that this delay will give them more time to develop an exit strategy. They simply will not be able to continue to run an economically viable institution given the costs to comply, the additional volatility to the financial statements the accounting changes will cause and need for additional capital that will result. They have serious concerns that these accounting changes will have such a significant impact on how they would manage their assets, liabilities and capital that their business model will no longer be viable. The result will be industry consolidation and loss of credit and other banking services to local communities.

### **Summary**

ICBA strongly opposes the accounting changes contained in the Exposure Draft and urges FASB not to go forward with it. The fair value accounting changes applied to financial institutions, particularly community banks, are more likely to mislead investors and financial statement users than provide them a clear picture of financial condition. The accounting changes that FASB proposes are dramatic and would cause all financial institutions, particularly community banks, to significantly change their accounting policies and practices. The changes will be expensive to implement but be of questionable value. Unfortunately, all financial institutions will likely need even more capital to offset the resulting increased volatility in financial instrument values.

We appreciate the opportunity to comment on this Exposure Draft. If you wish to discuss our comments further, please contact the undersigned at 202-659-8111 or email at [ann.grochala@icba.org](mailto:ann.grochala@icba.org).

Sincerely,

/s/

Ann M. Grochala  
Vice President  
Lending and Accounting Policy