MINUTES

Financial Accounting Standards Board

To: Board Members

From: Kubic (x296)

Subject: September 23, 2009 Board Meeting Minutes: Accounting for Financial Instruments

Date: October 15, 2009

cc: Leisenring, Golden, Bielstein, Stoklosa, Laungani, Lott, Proestakes, Mills, Wilkins, Maroney, Sangiuolo, Ampofo, H. Yang, K. Yang, Burnap, Kubic, Willis, C. Smith, Brickman, Homant, Chookaszian, Posta, Glotzer, Mechanick, Gabriele, Sutay, Finden, FASB Intranet, Klimek, McGarity

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final standard.

Topic:	Accounting for Financial Instruments: Deposit Liabilities
Basis for Discussion:	Board Memorandum No. 15
Length of Discussion:	2:00 to 3:45 p.m.
Attendance:	
Board members present:	FASB: Herz, Linsmeier, Seidman, Siegel, and Smith IASB: Leisenring
Staff in charge of topic:	Maroney and Laungani
Other staff at Board table:	Golden, Stoklosa, Sangiuolo, Ampofo, Homant, K. Yang, H. Yang, Wilkins, Burnap, and Kubic

Summary of Decisions Reached:

The staff provided the Board with a summary of the feedback received during the IASB's financial instrument roundtable meetings in Tokyo, London, and Norwalk and the FASB's discussion of core deposit liabilities with U.S. investors. The Board did not make a decision on which measurement attribute should be used to measure core deposit liabilities. However, the Board decided on an approach for remeasurement if the Board were to decide at a future date that such information would be useful to investors.

The Board agreed to a remeasurement approach that has the following characteristics:

1. A present value of the average core deposit liability amount discounted by the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity.
2. The core deposit liability amount that would be subject to the remeasurement would be determined as an average amount over the implied maturity time period, which would result in the consideration of future deposits. Considering and valuing future deposits would result in an intangible asset being reflected in the valuation.

Objective of Meeting:

The objective of the meeting was to discuss the development of a remeasurement approach that could be used to measure core deposit liabilities. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Summary of the IASB's Financial Instruments Roundtable Meetings

1. Ms. Laungani stated that because this is the first Board meeting since the IASB's roundtable meetings, the staff would begin today's meeting with a summary of the feedback received at the roundtables. Ms. Laungani stated that the FASB participated in all three roundtables.

2. Ms. Laungani stated that participants in the roundtable meetings consisted of both users and preparers. Most participants stressed the importance of both fair value and amortized cost information. At the Norwalk roundtable, some participants suggested that both amortized cost and fair value be prominently displayed on the financial statements. Various presentation alternatives were discussed, including dual presentation and parenthetical disclosure of the other measurement attribute.

3. Ms. Laungani stated that participants generally preferred a mixed attribute model for reporting financial instruments. Most preparers stated that they believe the financial statements should reflect the entity's business model. Users generally believe that financial instruments should be measured at fair value on the balance sheet.

4. Ms. Laungani stated that participants generally agreed that the classification criteria proposed by the IASB and the FASB for identifying which financial instruments must be measured at fair value with changes in fair value recognized in net income are similar. However, most participants requested clarification on the IASB's classification criteria and believe that the FASB's classification criteria may be easier to implement. Those participants suggested that the IASB further describe "basic loan features" and "managed on a contractually yield basis."

5. Ms. Laungani stated that many participants believe recycling into net income is important for financial instruments measured at fair value with changes recognized in other comprehensive income because net income is viewed as a key financial measure by many investors and analysts.

6. Ms. Laungani stated that some participants did not prefer either model for equity securities. Those participants believe that changes in fair value of equity securities should be permitted to be recognized in other comprehensive income with recycling.

7. Ms. Laungani stated that preparers from certain industries highlighted asset-liability management and suggested that the Boards consider these strategies when deciding on the measurement guidance for financial instruments.

8. Ms. Laungani noted that some participants stated that the current embedded derivatives guidance is too complex and should not be used to determine the classification of a financial instrument. Others prefer retaining the current bifurcation requirements rather than measuring the hybrid instrument as a whole.

9. Finally, Ms. Laungani stated that many participants expressed concerns about convergence and recommended that both Boards work together to develop a common standard for accounting for financial instruments. Many participants suggested that both Boards use identical language for financial instrument classification criteria.

10. Ms. Seidman noted that different constituents attended different roundtables, which resulted in a wide variety of views related to the FASB's model. Ms. Seidman noted that the staff had obtained additional feedback from users that was not always consistent with feedback received at the roundtables.

Summary of the Deposit Liability Outreach

11. Ms. Laungani stated that the staff spoke with preparers, auditors, and valuation specialists to obtain an understanding of valuation alternatives available for measuring core deposits. In addition, the staff held calls with 17 investors to discuss the types of information that would be helpful to investors in their analyses of core deposits. The staff contacted users with diverse perspectives, including buyside-long only, buyside-long and buyside-short, and credit rating agencies.

12. Ms. Laungani stated that investors are mixed in the views about the valuation of core deposits. However, almost all investors believe that asymmetric accounting for deposits and loans would not be helpful. If one is at fair value, the other should be at fair value.

13. Ms. Laungani stated that some investors believe core deposits provide a stable, cheap funding source and that the fair value of those deposits should be reflected in the financial statements, including the inputs and assumptions underlying the value inherent in the core deposits.

14. Ms. Laungani stated that some investors try to estimate the value of core deposits today using market-based information (and entity-specific information if available) about duration, spread, and discount rates. Understanding management's estimates for those factors would be a good starting point for analysis.

15. Ms. Laungani stated that some investors believe that volatility, such as that resulting from duration and interest rate exposure, would be revealed through fair value accounting for both core deposits and loans and would allow investors to make informed decisions.

16. Ms. Laungani stated that several investors noted that recording core deposits at the face amount more accurately reflects the economics of the transactions because it reflects the amount that would be paid today to settle the liability. They believe that recording a liability at an amount less than the face amount could be misleading.

17. Ms. Laungani stated that several investors noted that the fair value of core deposits could result in significant reliability and comparability issues in the financial statements. Determining the fair value of deposits would be a level 3 estimate with a significant number of inputs and assumptions; therefore, those investors believe that fair value is opaque and would not help transparency of financial reporting.

18. Ms. Laungani stated that some investors believe that small changes in assumptions could result in large effects on reported values in the balance sheet and income statement. This would lead to unnecessary volatility that could make the information hard to interpret.

19. Ms. Laungani stated that some investors would prefer to rely on a traditional net interest margin analysis coupled with an analysis of the expense structure of the bank and a detailed analysis of the funding base.

20. Ms. Laungani stated that some investors believe that current disclosures provide an adequate basis for their analyses of the deposit portfolio mix, sustainability of earnings, and an entity's funding base.

21. Ms. Laungani stated that the staff is also in the process of reaching out to banks of various sizes to get an understanding of their asset-liability management strategies. Generally, the staff understands that there is a correlation between the value of loans and the value of deposits. However, the movement is not dollar for dollar. In addition, the staff understands that banks not only manage interest rate sensitivity through their asset-liability management strategies but they also try to manage duration mismatches. The staff will provide the Board with a detailed summary of the banks' responses once completed.

Issue 1: Remeasurement Approach for Core Deposits

22. Ms. Maroney stated the staff would present two remeasurement approaches for core deposits for the Board to consider if the Board decides to require remeasurement of deposits at an amount other than the face value. The two approaches would be the financial instrument approach and the financial instrument with an intangible asset approach.

23. Ms. Maroney stated that the financial instrument approach is a present value of a floor core deposit amount discounted by the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity. The amount of core deposits above the floor would be measured at their net settlement or face amount. This model would align the valuation of core deposits with that of financial instruments. Ms. Maroney stated that the key inputs in the financial instrument approach would be core deposits, the discount rate, and the implied maturity.

24. Ms. Maroney stated that to determine the core deposit input management would need to identify a floor balance of core deposits by type, which would be a minimum amount that would be expected to be kept on deposit without taking into account future deposits over the implied maturity.

25. Ms. Maroney stated to determine the discount rate, the staff would ask constituents to consider the alternative funds rate minus the all-in-cost-to-service rate in determining the appropriate discount rate.

26. Ms. Maroney stated the implied maturity would be based on management's assessment of the average life by account type. This could be determined through an analysis of internal data or through an analysis of peer information. The staff notes that currently 10 years is considered an unofficial ceiling in terms of life on the basis of an entity's and its auditor's interaction with the Securities and Exchange Commission and regulators.

27. Ms. Maroney stated that the financial instrument with an intangible asset approach is based on a present value of an average core deposit amount discounted by the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity. The difference between this model and the financial instrument approach is that the core deposit amount would be measured at present value. The "core" amount would be determined as an average amount over the implied maturity time period, resulting in the consideration of future deposits, which would then result in an intangible asset being reflected in the valuation.

Issue 1 Board Vote

28. The Board decided to have the staff further develop a remeasurement approach that has the following characteristics:

    a. A present value of the average core deposit liability amount discounted by the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity.

    b. The core deposit liability amount that would be subject to the remeasurement would be determined as an average amount over the implied maturity time period, which would result in the consideration of future deposits. Considering and valuing future deposits would result in an intangible asset being reflected in the valuation.

29. Three Board members (Linsmeier, Siegel, and Herz) supported this approach. Two Board members (Smith and Seidman) did not support that approach.

Issue 1 Board Comments

30. Ms. Seidman stated that on Tuesday, September 22, 2009, the valuation resource group met to discuss the valuation of core deposits. She stated that the resource group only had experience in determining the fair value of deposit liabilities in business combinations. Ms. Seidman noted that the predominant method used by members of the resource group was not included in the staff's analysis. Ms. Seidman also noted that none of the methods outlined by the staff were called a fair value approach.

31. Mr. Maroney stated that the predominant approach used in a business combination to measure a core deposit at fair value was the cost savings approach. Mr. Stoklosa stated that the objective of that approach was to determine the fair value of an intangible asset. Thus, the objective cost savings model is different from a model that would be used to determine the value of the deposit base each reporting period. Ms. Maroney stated that the staff used this approach as a starting point for its analysis.

32. Mr. Stoklosa stated that the staff believes neither the financial instrument approach nor the financial instrument with an intangible asset approach is appropriate to be a fair value measure as defined in FASB Statement Number 157, *Fair Value Measurements*, because neither approach is based on an exit price notion. The staff believes both approaches could best be described as a remeasurement.

33. Ms. Seidman noted that the financial instrument with an intangible asset approach would involve the calculation of an intangible asset that is different from the intangible asset currently calculated in practice today. She noted that the intangible asset currently calculated in practice for business combinations includes the fair value of cross selling opportunities. The financial instrument with an intangible asset approach would calculate an intangible asset that does not include the value of cross selling activities.

34. Mr. Smith stated that the financial instrument approach would require an input called the "core deposit," which includes the estimate of a floor that does not include future deposits. Mr. Smith stated that it was not clear what is meant by "not taking into account future deposits." Mr. Smith stated that he would interpret that phrase to mean that the duration of the deposits would be extremely short, resulting in a very small "core deposit" input. Thus, in his opinion, the difference between the value calculated under the financial instruments approach and the face amount would be very small and would not provide benefits that would exceed the cost of the calculation.

35. Mr. Stoklosa stated that if the initial amount deposited into the deposit account remained in the account as a base amount over a long period of time, then duration would be longer and the "core deposit" input would be larger.

36. Mr. Golden observed that Mr. Smith understood "no future deposits" to mean that the core deposit input would be zero as soon as checks are written on the deposit account equal to the initial investment. Mr. Stoklosa stated that he does not look at the cash in a deposit account using an inventory basis such as LIFO or FIFO. He looks at cash as being fungable and whatever minimum balance is maintained in the account over an implied maturity is the amount that would be included in the "core" under the financial instrument model.

37. Mr. Golden noted that if the Board chose to further develop the fair value with a financial instrument approach, the "core deposit" input would have to be adequately defined.

38. Mr. Smith stated that of the two approaches the staff presented, the only approach he would support further developing would be the financial instrument approach. Mr. Smith stated that he believes the calculation of an "intangible" should not be in the scope of the project on accounting for financial instruments. Mr. Smith stated that if either model was to be further developed, it would require a substantial amount of work and coordination with valuation specialists.

39. Mr. Siegel stated that during the valuation resource group meeting, he tried to understand the link between the accounting for deposits and the accounting for loans. Mr. Siegel stated that he has heard feedback that loans and deposits should have the same measurement attribute. He reiterated the Board's decisions that a loan should be accounted for at fair value with changes in fair value recognized in other comprehensive income; therefore, he understands the conceptual reasoning behind accounting for deposits at fair value.

40. Mr. Siegel stated that he believes there would be a large amount of informational value in the inputs used to determine the value of a deposit liability, such as management's assessment of the implied maturity period. Mr. Siegel stated that he supports further exploration of the financial instrument with an intangible asset approach.

41. Ms. Seidman stated that she would consider what investors are currently doing with information about deposit liabilities and determine what investors would do with deposit liability information if deposit liabilities were carried on the balance sheet at a measurement attribute other than face.

42. Ms. Seidman stated that some investors use information about the estimated life of deposit liabilities to model net interest margins for an extended period of time. She noted that information about the deposits would affect the net interest margins because deposits are viewed as a cheap source of alternative funds. Ms. Seidman stated that other investors believe the intangible component is embedded in the deposit liability is an important indicator of the value of a bank. She noted that the intangible asset component is not a financial instrument. She expressed concern that if deposit liabilities were recorded with an intangible asset component, a precedent for recording internally generated intangible assets would be set. She stated that she believes the information investors want about deposit liabilities could be provided in footnote disclosures related to the average balance of deposits, implied maturity, and alternative cost of funds.

43. Ms. Seidman noted that deposits are a large portion of the liability side of the balance sheet for most banks. Thus, if the Board decided to measure those liabilities at something other than face, a majority of the liabilities on a bank's balance sheet would be measured using unobservable inputs. She stated that the recognition of an intangible asset is not within the scope of this project, and she has concerns about developing an approach to determine a value of deposit liabilities that would include an intangible asset component.

44. Mr. Linsmeier stated he believes it is important to consider all feedback related to financial instrument risk. In particular, he noted that over the past three decades many of the problems related to financial instruments have been with loan accounting. Thus, he believes it is necessary to record loans at fair value to capture interest rate risk and credit risk.

45. Mr. Linsmeier stated that the interest rate risk inherent in loans is directly related to the interest rate risk in deposit liabilities. He noted that some of the interest rate sensitivity of loans is counterbalanced by the interest rate sensitivity of deposits. He believes that it would not be fair to require banks to show all sensitivity to interest rate risk on the asset side without also showing any interest rate sensitivity on the liability side. Thus, he stated that he does not want a valuation of a deposit liability that would capture the intangible benefit from cross selling opportunities. He would prefer a valuation that shows the interest rate sensitivity of deposit liabilities. He noted that he supports the financial instrument with an intangible asset approach because he believes that approach would best reflect the interest rate sensitivity on the liability side of the balance sheet.

46. Mr. Smith stated that while the financial instrument with an intangible asset approach would reflect some of the interest rate sensitivity of deposits, it would also reflect other factors such as the intangible asset component. Thus, he believes reporting the deposit liability at an amount other than face would be misleading because investors could assume the change in value was from changes in interest rates, when in reality part of the change was due to some intangible asset component.

47. Mr. Linsmeier noted that even a complete deposit relationship includes services such as free checking. Thus, he believes if just the financial instrument portion of the deposit was measured, it would be less than face because a portion of cash received was for services.

48. Mr. Linsmeier noted that the implied maturity and measuring the all-in-cost-to-service would be difficult inputs to determine. He stated that if there was ample guidance as to what exactly those factors should consist of, then the financial instrument with an intangible asset approach would be an effective way to determine the value of a core deposit and would provide useful information to investors.

49. Ms. Seidman stated that the valuation resource group had not valued the financial instrument portion of a deposit liability separately from the intangible portion. Instead, the valuation of the deposit liability included the valuation of an intangible asset related to customer relationship. She noted that members of the resource group had never considered how to determine the fair value of just the financial instrument piece of a deposit liability.

50. Mr. Herz noted that at the July 29, 2009 education session, an expert on deposit liabilities presented an approach that could be used to value only the financial instrument component of a deposit liability.

51. Ms. Seidman stated that if an exit price notion was used to determine the fair value of deposit liabilities, the unit of account would be the entire deposit arrangement, which would include a significant intangible asset.

52. Mr. Herz stated that there were many transactions in accounting that are sensitive to interest rate movements. He noted that he could create a balance sheet with interest paying assets that had the same principal amounts, but different contractual rates, and all of those assets would be reported on the balance sheet at the same amount. He believes this is inconsistent because the underlying economics of each of those instruments is different. Thus, he believes recording those instruments at fair value is necessary to reflect the different values of those instruments. He agrees with Mr.

Linsmeier that if those assets are on the balance sheet at fair value to reflect interest rate sensitivity, then liabilities such as deposits should also be displayed at fair value.

53. Mr. Herz stated that he supports developing the financial instrument with an intangible asset approach to determine if it is operational and reliable. Mr. Herz admitted that the value of a deposit liability may include an intangible asset component. However, he noted that the measurement of mortgage servicing rights includes a small intangible portion.

54. Mr. Herz noted that in the past when the Board was faced with a situation in which it was difficult to determine the measurement attribute, the Board has constructed models that it believes best portray the underlying economics. He stated that these models needed to be tested before implementation, and he suggested a similar approach to developing an approach to remeasure deposit liabilities.

55. Mr. Herz stated that he supports the financial instrument with an intangible asset approach because he does not want to measure the customer relationship. He would prefer to measure the revolving nature of a cheap source of funding.

56. Mr. Herz noted that a similar issue could be raised on the asset side when accounting for credit card receivables. He stated that he is not sure if there is a value related to a credit card relationship similar to the value in the deposit relationship.

57. Mr. Leisenring noted that in the past the Board has been hesitant to realize gains on liabilities that would not be realizable. He is not sure if a change in value of the deposit liability would be realizable. He expressed significant concern about recognizing deposit liabilities at an amount other than face.

Follow-Up Items:

58. The Board asked the staff to do further research a remeasurement approach with the following characteristics:

    a. A present value of the average core deposit liability amount discounted by the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity

    b. The core deposit liability amount that would be subject to the remeasurement would be determined as an average amount over the implied maturity time period, which would result in the consideration of future deposits. Considering and valuing future deposits would result in an intangible asset being reflected in the valuation.

General Announcements:

59. Mr. Golden discussed the future steps necessary to develop a complete model for the accounting for financial instruments and the importance of coordination with the IASB.

60. Mr. Golden stated that the IASB Board members decided to create an impairment model based on expected cash flows and to create an expert advisory panel to assist with technical issues related to the model. He stated that the FASB would work jointly with the IASB on the expert advisory panel, and the two Boards would work toward developing a converged impairment model. He stated that impairments would be addressed at the October 26, 2009 joint Board meeting.

61. Mr. Golden stated that it seems that investors believe there is value in both an amortized cost number with credit impairments and a fair value number. Investors who were contacted during the staff's outreach efforts noted that they agree that each number should be presented in a timely manner. He noted that at the August 13, 2009 Board meeting, the Board decided to provide that information to investors. Based upon this feedback, the FASB and IASB staff will prepare a joint memorandum for discussion at the October joint Board meeting.

62. Mr. Golden also stated that the FASB staff will analyze similarities in the classification criteria for the FASB's and the IASB's models.