



May 6, 2009

Mr. Timothy F. Geithner
Secretary of the Treasury
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Ms. Sheila C. Bair
Chairman
Federal Deposit Insurance Corporation
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Washington, DC 20429

Dear Secretary Geithner, Chairman Bernanke and Chairman Bair:

In recent months, the impact of fair-value accounting (also known as mark-to-market accounting) on financial institutions and the capital markets has been the focus of considerable controversy. An equally controversial topic is the manner in which banks record losses in their loan portfolios. Both issues hinge on two factors:

1. Investors' right to and need for transparent and objective financial information that accurately presents corporate performance in a comparable form across various investment opportunities; and
2. The effect that financial statements prepared in accordance with generally accepted accounting principles (GAAP) have on regulatory capital requirements — as well as the corresponding effect those requirements have on the operations of financial institutions, including banks and other financial institutions.

Grant Thornton LLP supports the position that additional guidance by the Financial Accounting Standards Board (FASB) was necessary in order to address certain misunderstandings and inconsistencies in GAAP. To that end, we believe the prompt action taken by FASB in early April regarding fair-value measurements and other-than-

temporary impairments was appropriate. However, we believe that greater opportunities exist *within the current regulatory framework* to address the continued perception by some that current GAAP needs further revision — opportunities that, if acted upon, will preserve investor information, enhance the safety and soundness of our financial institutions and provide a level of stability and predictability that financial institutions, investors, regulators and other stakeholders will value.

This letter is intended to provide a broad outline of our proposal, which is centered on the two core issues of fair-value accounting and the allowance for loan losses.

Fair-Value Accounting

Some financial institutions believe that fair-value accounting forces them to write down certain financial assets to a level below the value they expect to recover in the long term. Further, they assert that these write-downs compel them to curtail lending activities, preserving capital solely to meet certain regulatory requirements. Their proposed changes, even after considering FASB's recent actions, often involve suspending fair-value accounting or modifying it such that management may calculate and report its own estimates of "fair value" with minimal regard for current sales prices in the marketplace. The likely result will exceed the value calculated using recent sales prices of similar assets.

Other stakeholders, including investors (who are the primary users of financial statements) and auditors, believe that properly applied fair-value accounting provides the most transparent picture of the relative financial condition of an organization. This level of transparency enables investors to compare more effectively similarly situated organizations — even in a declining market — thereby facilitating the allocation of investment capital to the best performers. Investors rightly fear that overly minimizing or eliminating recent sales prices from the fair-value equation will reduce significantly their ability to analyze company performance and make wise investment choices. This limitation subsequently reduces their willingness to invest in the very institutions that so urgently need private capital investment.

Many of the arguments for and against fair-value-accounting are legitimate. In extreme economic times — positive or negative — fair-value accounting that relies heavily on recent sales prices will, at some point, price-in either irrational exuberance or irrational fear. In other words, the influence (real and psychological) of recent sales prices in these environments will not reflect reasonable expected future cash flows. Investors, on the other hand, are justified in demanding transparency and objectivity in the financial-reporting process. Just as banks today require a recent independent appraisal before making a home loan, investors in those banks have a right to know how the marketplace values the bank's financial assets.

We believe that prudential regulators can play a much greater role in addressing any remaining concerns regarding application of fair-value accounting principles with respect to financial institutions — a role that will (1) protect more effectively the safety

and soundness of financial institutions that are vital to the economy; (2) discourage excessive risk-taking in a booming economy; (3) provide necessary capital cushions in a declining economy; and (4) still provide the financial-statement transparency and objectivity needed by investors. The solution we propose — which includes encouraging regulators to utilize dynamic regulatory capital requirements — has been mentioned in various hearings and news articles, but nowhere have we seen (1) its broad benefits expounded upon or (2) its practical implementation discussed. We seek to do both in the remainder of this letter.

Dynamic Regulatory Capital Provisioning

The capital requirements for regulated financial institutions are static, regardless of the economic climate and the degree of systemic risk created by each entity.¹ In order for a bank to be considered “well capitalized,” for example, the minimum ratio of total capital to risk-weighted assets is 10 percent. This ratio has been constant since the establishment of the current bank regulatory capital structure in the early 1990s. From time to time, regulators have changed the risk weightings of certain assets in that calculation, but the overall minimum ratio has remained constant in both up and down markets. However, in the midst of today’s economic crisis, we see clearly that many banks do not have adequate capital to enable them to operate their core business rationally. In retrospect, had the banks (especially those that create systemic risk to the entire banking system) built up greater capital cushions in the best economic times, they would now have an adequate cushion for weathering the bad times.

We propose that bank regulators exercise their authority to adjust capital requirements to account for different economic environments, thus providing “dynamic regulatory capital provisioning.” Taking this approach would increase capital requirements in booming economies and decrease those requirements in strained ones. The advantages of such an approach are many:

1. In prosperous economies, financial institutions often invest in increasingly risky assets in order to drive income and compete in the marketplace. An increase in the overall capital requirements in such economies would serve as an effective braking mechanism by reducing the capital available for potentially excessive risk-taking. Further, the reduction in excessive risk-taking would redirect public investment in these institutions toward investors who look for long-term value creation rather than short-term earnings.
2. In struggling economies, the additional accumulated regulatory capital would provide the necessary cushion and time frame for institutions to absorb losses and hold, or seek more orderly liquidation of assets. This process would, in turn, prevent dramatic declines in sales prices (and, thus, fair value) across other institutions.

¹ The announcement of increased capital requirements for certain financial institutions as a result of the recent stress tests is an exception to the long-standing static nature of capital requirements.

3. The counter-cyclical declining capital requirements in weak economies would enable financial institutions to operate their core lending businesses rationally, without limiting them to capital requirements better suited to stable economic environments.
4. GAAP would be separated more effectively from the regulatory capital requirements, thereby enabling investors to have the information they need while at the same time providing regulators the tools they need to properly monitor financial institution safety and soundness.

Regulators can attain the goal of dynamic regulatory capital provisioning in several ways:

1. By working with financial institutions, finance professionals and the academic community, regulators can develop a set of global and national economic thresholds (with corresponding triggers) designed to raise or lower capital requirements for all institutions in a given group (e.g., commercial banks and savings banks and/or thresholds based on size and level of systemic risk). Similarly situated institutions could then be treated in the same way, providing a level of predictability about the direction of capital requirements for financial institutions and their stakeholders.
2. The counter-cyclical changes in capital requirements could be spread over a longer period of time in up markets and allow for faster adjustment in down markets. This approach would minimize the shock of increasing requirements, while simultaneously allowing for prompt adjustment during a downturn — a time when capital is being used to absorb losses.
3. Regulators can develop a more robust and transparent process for establishing and adjusting the risk weightings of assets that are included in the capital ratio calculations. With the ability to evaluate new financial instruments quickly, regulators will have greater flexibility in modifying the calculation of capital ratios as complexities and risks change in the investment landscape. The process might include criteria for establishing risk weights, as well as a public exposure period to solicit valuable feedback on proposed changes in the capital ratio calculations.
4. As a last resort, regulators should be ready to require changes to an individual institution's capital requirements (changes either in the form of the calculation or in the required ratios) if certain risk characteristics exist. Such characteristics might include systemic risk indicators, the results of recent regulatory examinations, and the presence of highly unusual operating statistics or unusual transactions with a high degree of risk.

Allowance for Loan Losses

Bankers, and particularly regulators, desire to build loan-loss reserves in good times so that those reserves can be used to cushion the blow in bad times — a model often referred to as “dynamic loan-loss provisioning.”² Industry jargon often refers to these provisions as “cookie-jar reserves.” From the standpoint of taking prudent action to prepare for unknown future losses, the “cookie-jar reserve” approach is difficult to dispute. It does indeed have merit from a safety and soundness perspective, but only because it creates a *disguised* form of capital held in the allowance account, rather than in the capital accounts. For investors, however, it has serious negative consequences.

Imagine a baseball team that is allowed to transfer runs from a game against a weaker opponent to another game against a stronger opponent. Related box scores would lose their meaning. Likewise, financial statements with smoothed earnings do not provide an adequate picture of performance for investors.

In this way, building reserves in good times and using them in bad clouds reality for investors and lowers their overall confidence in the system. A banker who uses excess allowances to smooth earnings in down years could be masking poor management decisions rather than simply responding to a downturn. Because investors have no way of knowing the truth, they typically perceive their risk to be greater, a belief which translates into higher cost of capital. Some assert that allowances with built-in cushions protect the bank, but the reality is that allowances *don't* protect the bank from losses; they only protect reported earnings from larger loss provisions in periods when the losses actually occur. To a degree, then, they protect management and regulators, not the bank. Indeed, the very existence of a cushion to earnings may *encourage* more reckless investment and lending activity.

Dynamic regulatory capital provisioning, as outlined in our proposal, can solve the dilemma without changing GAAP to allow for income-smoothing. Loan losses would be charged against earnings as they occur, but the increases in capital requirements in good times would provide the desired cushion in bad. Declining capital requirements would offset increases in loan-loss allowances when incurred losses are recognized in the financial statements.

Conclusion

All stakeholders benefit from steps taken to (1) ensure the transparency and objectivity of financial information for investors, and (2) improve the safety and soundness of our financial institutions. Unfortunately, steps taken to attain certain objectives sometimes impede the ability to attain others. All of the objectives presented here, however, are attainable.

² “Dynamic loan-loss provisioning” is contrasted with our proposed “dynamic regulatory capital provisioning.” The former distorts financial statements and prevents their transparency in providing investors with important financial performance information. The latter puts the dynamic-provisioning tool in the hands of regulators, thereby enabling them to protect more effectively the safety and soundness of the institutions they regulate.

GAAP provides a solid foundation of information for investors. It is not perfect and should be amended when and where necessary for the purpose of furthering investor information needs. Its wholesale abrogation in order to achieve certain operational objectives should be avoided — especially as we have better alternatives in the form of counter-cyclical changes to regulatory capital requirements. By exercising their ability to change regulatory capital requirements — increasing the requirements in good times and decreasing them in bad — prudential regulators can provide predictable, behavior-changing parameters that would minimize risk-taking on the upside and maximize much-needed capital on the downside.

We at Grant Thornton encourage a greater exchange of ideas related to this matter and look forward to participating in its resolution. If you have any questions, please contact R. Trent Gazzaway, Managing Partner of Public Policy and Corporate Governance, at 202.521.1545 or Trent.Gazzaway@gt.com.

Sincerely,

/s/ Grant Thornton LLP

cc:

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