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Subject: New Proposed Accounting Rules Require Mark-to-Market of Financial Instruments

Major References: [***FASB Proposed Accounting Standard Update: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities \(May 26, 2010\)***](#)

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A controversial proposal on the accounting for financial instruments has been released by the Financial Accounting Standards Board (“FASB”). Controversial because of the dramatic change it would make to the rules, the proposal would require fair value measurement of essentially all financial instruments, including loans held to maturity. Currently, financial instruments that are held to maturity are measured at amortized cost. This change would largely affect the balance sheets of commercial banks that have a large investment in financial instruments currently measured at amortized cost. Potential adverse consequences for the amount of life insurance that can be owned by banks may develop if this proposal is ultimately adopted.

FASB’s proposal would require essentially all financial instruments to be marked to fair value, with limited exceptions (e.g., pension obligations, leases). Regardless of whether a company intends to hold the financial instrument until maturity to collect the payments, the company would be required to measure the instrument at fair value. For financial instruments that the company intends to hold-to-maturity, the company would then report both the new fair value and the old amortized cost. Currently those instruments

the company intends to hold-to-maturity are only measured and reported at amortized cost. Those financial instruments that the company intends to trade or make available-for-sale would continue to be reported at only fair value.

Changes in the fair value of financial instruments that a company intends to trade continue to be recognized in net income. Changes in the fair value of financial instruments that a company intends to hold-to-maturity are to be recognized partly in net income and partly in other comprehensive income. FASB notes, though, that for these hold-to-maturity instruments, net income will remain largely unchanged, with only changes resulting from interest accruals, credit impairments and realized gains and losses to be recognized in net income. The proposal would remove the probable threshold for credit impairments, so that the effect of credit impairment on fair value would be recognized immediately.

The change in guidance could have an effect on the way regulators calculate capital amounts, because the regulations specifying the calculation of capital are interwoven with the accounting guidance. As such, the FASB proposed the dual reporting of both fair value and amortized cost to allow regulators the option of calculating capital at either amortized cost or fair value.

Even so, the calculation of fair value has many observers concerned over the potential implications to the regulatory capital requirements. A decrease in the value of a bank's assets could decrease a bank's calculation of capital and thus, the of the face amount of life insurance the bank may hold.

It is generally thought that, in today's economy, the fair value of many banks' loans receivable is below the amortized cost of such loans. If so, the adoption of this proposal would ultimately cause a reduction in bank capital. With that reduction, the purchase and continued holding by those banks of life insurance policies (BOLI) could meaningfully be impaired. We understand that the proposal is being opposed by the American Banker's Association, a politically active and powerful group.

While the proposal does not provide an effective date, FASB has stated that the update is expected to take effect in 2013. The guidance would apply to all companies with financial instruments, except that nonpublic entities with less than \$1 billion in total assets will have four years to implement the changes. To apply the proposed standard, the company would make a cumulative-effective adjustment for the reporting period that immediately precedes the effective date.

The proposal, in the form of an exposure draft, suggests amendments to the FASB Accounting Standards Codification ("FASB ASC"), the authoritative source for all U.S. generally accepted accounting principles. The draft proposes changes to the guidance regarding financial instruments (FASB ASC 825) and derivatives and hedging activities (FASB ASC 815). Comments are due September 30, 2010.

Any AALU member who wishes to obtain a copy of the FASB Proposed Accounting Standard Update: Accounting for Financial instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*. As of the date this *Washington Report* is being completed neither of the above texts is available. It may therefore take some time before we can satisfactorily respond to your requests for copies.

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