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July 29, 2011

Mr. James L. Kroeker, Chief Accountant
Office of the Chief Accountant
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

BY EMAIL: kroekerJ@sec.gov

RE: File No. 4-600
Staff Paper on "Condorsement" Incorporation of IFRS (May 26, 2011)

Dear Mr. Kroeker:

On behalf of Sandler O'Neill + Partners, L.P., I am commenting on the May 26, 2011 staff paper *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: Exploring a Possible Method of Incorporation* ("Paper"), issued by the Office of the Chief Accountant for comment.

Sandler O'Neill is a full-service investment banking firm and broker-dealer focused on the financial services sector.[1] We address the staff not as accountants but as a firm of financial professionals who work closely with a wide variety of financial firms nationwide and, increasingly, around the globe, hundreds of which are publicly reporting.

Staff Paper Overview

The Paper focuses on a method of incorporating International Financial Reporting Standards ("IFRS") into U.S. GAAP, which the Securities and Exchange Commission ("SEC") staff has dubbed "condorsement." Condorsement combines elements of "convergence," a country's gradual movement toward existing IFRS, and "endorsement," a country's adoption of IFRS, with any modifications deemed necessary, pursuant to an established protocol.[2]

[1] For further information on Sandler O'Neill + Partners, L.P., see http://www.sandleroneill.com/; author contact information: jlongino@sandleroneill.com or 212-466-7936.
[2] The staff notes that although the joint projects between the FASB and the IASB are often denominated "convergence," those projects (also known as the "MoU projects") are "different from the Convergence Approach described here. The FASB-IASB process involves movement by both standard setters toward a new, mutually-acceptable high-quality standard, while the Convergence Approach involves movement by a country toward existing IFRS." Paper, p. 5, n. 9.

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During a transitional "convergence" period of perhaps five to seven years, the Financial Accounting Standards Board ("FASB") would focus on efficiently addressing existing differences between U.S. GAAP and IFRS, issued by the International Accounting Standards Board ("IASB").[3] At the conclusion of this transition period, the goal "would be that a U.S. issuer compliant with U.S. GAAP should also be able to represent that it is compliant with IFRS as issued by the IASB" (Paper, p. 7).

In the ensuing "endorsement" environment, the SEC staff envisions the role of the FASB to be primarily that of assisting the IASB in developing and improving IFRS, which the FASB should then be able to endorse promptly as U.S. GAAP. The staff contemplates that the FASB would modify IFRS in endorsing it only rarely, as is currently the case with SEC deviations from U.S. GAAP (Paper, pp. 8-11).

Convergence In Context

In September 2010 the FASB and IASB converged upon common core principles to govern their setting of accounting standards. The most fundamental of these is the same for the Boards:

> The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.[4]

The Boards identify investors, lenders, and other creditors as the "primary users" of general-purpose financial statements, whose needs the Boards have committed themselves to addressing as their raison d'être.[5]

By contrast to the primacy of due process in serving primary users, there is but a single passing reference to convergence in the FASB's Concepts Statement No. 8. In that

[3] Together, the FASB and IASB are referred to herein as the "Boards."
[4] FASB, Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting* (Sept. 2010), ¶ OB2; IASB, *Conceptual Framework for Financial Reporting: Project Summary and Feedback Statement* (Sept. 2010), p. 4. Concerning the financial information to be provided primary users, the FASB continues: "General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders, and other creditors to estimate the value of the reporting entity" (¶ OB7). We question the consistency of much fair value accounting with this core concept. If fair value accounting is often inappropriate for earnings, how can it be appropriate for equity?
[5] The Boards exclude regulators from the cohort of primary users because regulators can "require reporting entities to provide information directly to them." FASB, Concepts Statement No. 8, ¶ BC1.9. The only role Concepts Statement No. 8 assigns academics (along with preparers, users, and auditors) in the development of accounting standards is consultation on the cost-benefit analysis of a proposed standard (¶ QC38).

Statement, convergence clearly is what it should be: a secondary, aspirational principle of action to be given effect *only* if consistent with its primary, mandatory desiderata.

Fix Due Process: Convergence Will Follow

We believe the most pressing agenda item for the Boards is not the international convergence of accounting standards but better due process in the way the Boards develop and update accounting standards. We further believe that if the Boards were to commit themselves to responding more substantively and consistently to primary users in developing and updating accounting standards, the international convergence of such standards would largely take care of itself.

Too often the Boards' accounting "solutions" have been driven not by the pragmatic input of primary users but by ideology originating elsewhere, together with an accompanying lack of empiricism in identifying problems to be addressed. Nothing better illustrates the Boards' failures of due process than the nexus of fair value initiatives, three of which are particularly pertinent historically and currently: financial assets, impairment, and insurance contracts.

Financial Assets

Fair value ideology originated in the wake of the thrift crisis in the United States two decades ago. Although the FASB had formally committed itself to serving "external users who lack the authority to prescribe the financial information they want from an enterprise"[6] (primary users rather than regulators), the FASB explained the genesis of SFAS No. 115 as follows:

> This Statement was undertaken mainly in response to concerns expressed by regulators and others about the recognition and measurement of investments in debt securities, particularly those held by financial institutions. They questioned the appropriateness of using the amortized cost method for certain investments in debt securities in light of certain trading and sales practices.[7]

In point of fact, however, the accounting culprit-in-chief of the 1980s thrift crisis was not amortized cost or the gains trading it enabled but, rather, the recognition by GAAP and the federal thrift regulator of goodwill as an asset, and by the federal thrift regulator of supervisory goodwill.[8]

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[6] Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises* (Nov. 1978), ¶ 28.
[7] Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (May 1993), ¶ 2.
[8] Whereas goodwill represents the acquisition premium paid in excess of the fair value of assets of a solvent firm, supervisory goodwill represented the fair value excess of liabilities over assets

From 1981 to 1984 the net worth of FSLIC-insured[9] thrifts as a percentage of assets declined from 4.3% to 3.7% on a RAP basis and from 4.2% to 2.6% on a GAAP basis, while on a tangible basis it plummeted from 3.9% to 0.3%. By 1984 goodwill and supervisory goodwill, not historical cost accounting, largely enabled one-fifth of the thrift industry – with over one-third of its assets – to avoid reporting insolvency.[10]

To have suggested that the lack of fair value accounting prevented policymakers, examiners, accountants, or investors in stock thrifts from detecting or assessing financial ruin of this magnitude was nonsense. There were many failures during the thrift crisis, but historical cost accounting was not among them.

The enormous irony here is that during its two-decade crusade for fair value as *the* accounting panacea, the FASB has not addressed GAAP's recognition of goodwill as an asset except to replace amortization with indefinite duration on the balance sheet, limited only by impairment. By contrast, the federal banking agencies long ago uniformly banished goodwill from regulatory capital. Magnifying this irony, the federal banking agencies responded to the equity volatility inherent in SFAS 115 by excluding from regulatory capital the fair value adjustment to equity required for available-for-sale debt securities.

In short, the FASB's two-decade crusade for ever more fair value for financial assets originated in misidentification of the central accounting problem of the U.S. thrift crisis, which it never addressed. The belated but welcome news is that under its new chairman the FASB has recently relented from vastly expanding fair value accounting in response to overwhelming opposition from every constituency, including primary users.

Impairment

Undue regulatory influence in setting the Boards' agendas and lack of empiricism in identifying problems are also at work in the Boards' proposals for expected-loss reserving.[11] By contrast, the needs and strong preferences of primary users are not reflected in their joint proposal.

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in the acquisition of an insolvent thrift recognized not by GAAP but by regulatory accounting principles (RAP) applied by the Federal Home Loan Bank Board, predecessor agency to the Office of Thrift Supervision.

[9] Federal Savings and Loan Insurance Corporation, the former federal insurer of thrift deposits.

[10] See Lawrence J. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation* (Oxford U. Press, 1991), pp. 86-87, Table 5-10 in particular. White advocates fair value accounting as a preventative of "gains trading," or selling appreciated assets while holding depreciated ones (pp. 225-229). Gains trading, however, was a minor irritant in the annals of historical cost accounting.

[11] FASB, Supplementary Document, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment* (Jan. 31, 2011) ("*Impairment*").

Specifically, the Basel Committee on Banking Supervision criticized incurred-loss impairment models in use during the recent financial crisis for (i) not recognizing losses soon enough, (ii) not incorporating information forward-looking enough to encompass the lifetime of assets and complete economic cycles, and (iii) not providing a uniform approach to the impairment of similar assets.[12]

The Real Problem: Underwriting, Not Reserving

The problems of the recent financial crisis did not result from an inability to reserve for probable credit losses proactively enough. Rather, as the analysis of surviving banks in Appendix A to this letter demonstrates, the fundamental failure was underwriting. For the best-performing quartile of banks, reserves remained adequate to cover nonperforming assets. For the worst quartile of banks, NPAs quickly and dramatically overwhelmed reserves. Needless to say, banks that failed performed much worse than the worst quartile of surviving banks.

To be clear, any bank capable of apprehending the magnitude of expected losses for the worst-performing assets during the financial crisis simply would not have originated or acquired those assets. Thus, the crux of the problem was not an incurred- versus expected-loss approach to reserves but, rather, that the financial system was awash in too many assets for which no reserve methodology would have been adequate. For the best banks, incurred-loss reserving worked just fine, and for the worst banks no impairment methodology would have helped because the fundamental failure was one of underwriting, not reserving.

What Primary Users Want

During the week of March 14, 2011 the Investment Strategy Group of Sandler O'Neill conducted a survey of bankers and institutional investors in banks who receive research from the firm's Equity Research Department regarding their views on the reserving methodologies proposed by the Boards. Of 73 total responses, 46 were from bankers and 27 were from institutional investors.

Fully 70% of institutional investors opposed both the IASB/FASB joint approach and the FASB alternative approach, while 81% of investors supported current practice. Minorities of 30% of investors supported both the joint approach and FASB approach, with only 19% opposing current practice.[13]

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[12] See Basel Committee on Banking Supervision, Guiding Principles for the Replacement of IAS 39 (Aug. 27, 2009), p. 3. See also FASB, *Impairment*, ¶¶ IN1 to IN3.

[13] The results for bankers were similar but more pronounced: majorities of 93% and 91% opposed the IASB/FASB joint approach and FASB alternative approach, while 96% supported current

Our survey was admittedly limited, but we have no reason to believe that a more scientific sampling would yield substantially different results. What is particularly striking is the lack of support for either the IASB/FASB joint approach or the FASB alternative approach to the current incurred-loss model among institutional investors, the primary users whom the Boards most seek to serve in developing accounting standards.

Insurance Contracts

Begun in 2002 and joined by the FASB in 2008 as a joint project, the IASB proposal on accounting for insurance contracts would radically transform financial reporting by insurance companies and just as radically complicate both equity and debt investments in them.

The FASB has discussed a technical variant of the IASB's proposal, but it has also indicated openness to the alternative of what it terms "targeted improvements" to U.S. GAAP. For reasons explained below, we hope that the FASB will opt to provide an effective counterweight to the IASB's overreaching, unhelpful proposal.

The "Solution" Is The Problem

Despite lacking a credible pretext in the role of insurers in the recent financial crisis for pressing forward, the IASB has proposed nothing less than the application of an onerous version of theoretical fair value accounting through earnings for insurance contracts, regardless of:

- the fact that there is no market for insurance contracts, with the result that discount rates for liabilities with durations of up to 40 years or more are largely speculative
- the fact that small changes in these speculative discount rates would create volatility that would overwhelm the earnings and equity of insurers
- the fact that the business model of insurers is to hold rather than extinguish these liabilities early
- the facts that U.S. GAAP for insurance contracts is a fully articulated, nuanced, and functioning approach reasonably calibrated to provide granular, transparent, and relevant financial information to primary users, and that it did so throughout the recent financial crisis
- the fact that U.S. GAAP for insurance contracts is accepted not only by U.S. insurers and investors but by many insurers and investors worldwide.

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impairment practice. Minorities of 7% and 9% of bankers supported the joint approach and FASB approach, with only 4% opposing current practice.

In the face of these counterfactuals, one thing, and one thing only, is clear: the IASB's proposed model for insurance contract accounting is fully compatible with Solvency II, sometimes called "Basel for insurers." In the long and tangled history of its insurance contracts project, the point here is not whether the IASB took its cue from European insurance regulators or vice versa, but, rather, that a proposed theoretical accounting model that European regulators are comfortable with is diametrically opposed to the real-world needs and preferences of primary users, and thus profoundly at odds with the due process to which the IASB has committed itself.

Finally, although U.S. GAAP for insurance contracts is not perfect, replacing an imperfect standard needing only minor adjustments with a far less perfect, totally untested one is neither rational nor consistent with due process. Properly understood, the burden of persuasion placed upon the Boards is to demonstrate that what they are considering is better for primary users than U.S. GAAP with targeted improvements. This they have not done because they cannot.

What Primary Users Want

Bernstein Research recently published the results of its in-depth survey of the opinions of institutional investors on the insurance contracts proposal.[14] Of the approximate 45 respondents, 81% were not supportive of the proposed quarterly fair valuing of insurance liabilities; none favored reflecting the fair value adjustment through earnings rather than equity outside earnings, which the industry had suggested as a less damaging alternative; 81% indicated that the proposal would decrease or significantly decrease their understanding of the economics of the insurance industry; and only 7% believed they had been given adequate time to provide their feedback on the proposal.

Sandler O'Neill's Equity Research Department had earlier published the results of a simpler survey of institutional investors, in which 100% of a smaller number of respondents preferred U.S. GAAP, either as is or with modifications, and 86% believed the proposal would make analyzing insurance companies more complicated.[15]

The FASB summary of user feedback is generally consistent with these surveys in the overwhelming dissatisfaction with the proposal that it documents.[16]

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[14] Suneet Kamath, Andrew Fernandez & Sam Rosenberg, *Life Insurance: Results from Bernstein Investor Survey of Proposed IASB/FASB Accounting Changes*, April 21, 2011. See the survey for additional results.
[15] Paul Newsome & Edward Shields, *Survey Results on Coming Insurance Accounting Changes*, March 8, 2011. See the survey for additional results.
[16] FASB, *Insurance Contracts Project: User Feedback*, available on the FASB website at http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175822582479&blobheader=application%2Fpdf.

***Stare Decisis*: A Maxim To Converge By**

There is a legal maxim the boards would do well to follow: *stare decisis*, "stand by things decided," the principle that past decisions should stand as guides for future decisions.

- In setting accounting standards, this maxim translates into a strong presumption that the Boards have largely "gotten it right" in existing guidance.
- Only compelling evidence developed through the application of dispassionate due process should be allowed to rebut the presumption that current guidance is generally serviceable for primary users.
- A preference for targeted improvements rather than overreaching replacement should guide needed revision – gradualism rather than revolution should be the Boards' modus operandi.

Restoring the confidence that their ideology-driven detours have cost the Boards will require them to re-examine carefully how they interact with each other, their trustees, and their staffs, as well as primary users, whose needs have too often been honored in the breach. If the Boards are capable of this, we believe the accounting standards they develop jointly as coequal partners will converge in due course as they more consistently and substantively respond to the pragmatic needs of primary users rather than to impractical ideologies originating elsewhere.

Concluding Thoughts

The first phase of IFRS 9 and the IASB's insurance contracts proposal provide grounds for both hope and doubt regarding convergence. As a result of significant IASB outreach and openness to input, the first phase of IFRS 9 concluded in guidance that puts the business model front and center in the measurement of financial assets, supplemented by attention to their contractual cash flow characteristics.

Aided by this example and significant opposition to its recent overreaching proposal to expand fair value accounting, under its new chairman the FASB sufficiently overcame ideology to respond constructively to primary users and other constituents. It remains to be seen whether under its new chairman the IASB is capable of responding in kind on its insurance contracts proposal, which could well be a test case for the prospects of the convergence of international accounting standards upon the needs of primary users.

Of this we are confident: the status of both Boards as coequal partners contributed to the good outcome in accounting for financial assets and is the best hope for a good outcome on insurance contracts. As a result, we view with concern the possibility that within a few years the FASB could become an appendage of the IASB.[17] We believe that

[17] "For the endorsement aspect of the framework, the FASB would continue to participate in the development and improvement of accounting standards that foster high-quality financial reporting

preservation of the two Boards' status as coequal partners would better promote their mutual solicitude for primary users, thereby providing a better foundation for the constructive convergence of international accounting standards.[18] For the foreseeable future, preservation of a duopoly of imperfect Boards in setting accounting standards would better serve primary users than a monopoly.

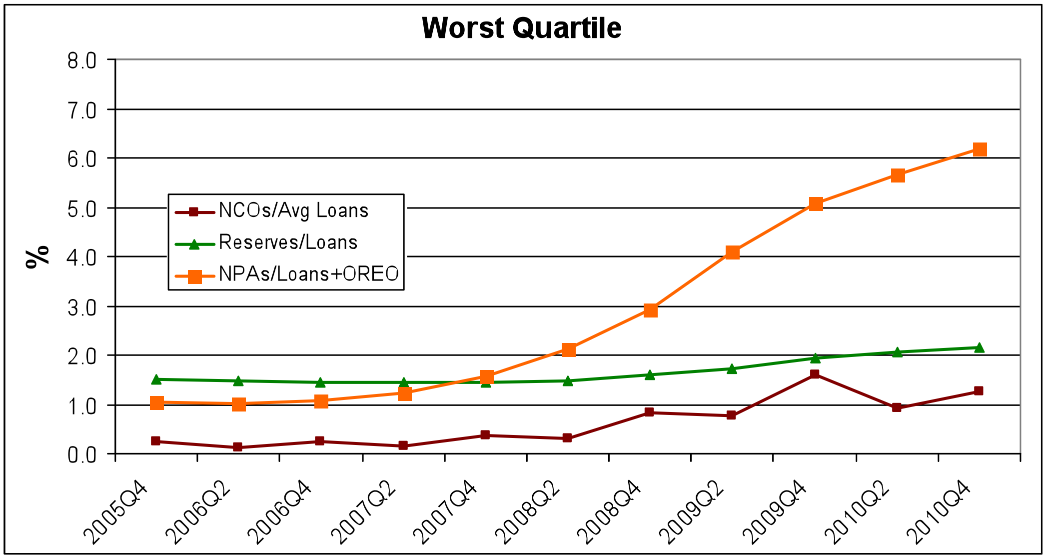
Very truly yours,

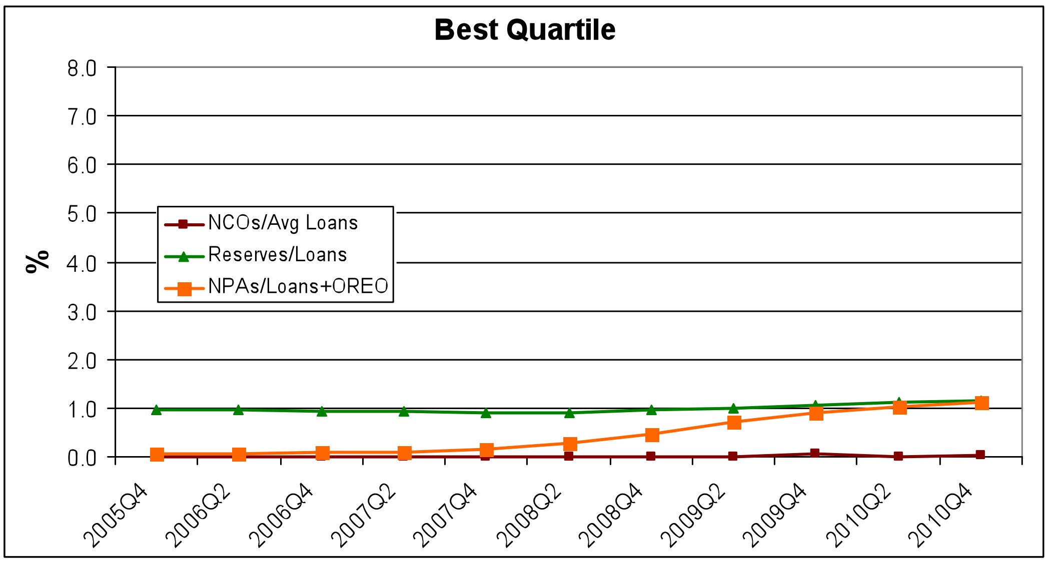
Joseph Longino
Principal

that provides decision-useful information to investors and other users of financial reports. However, the manner of participation as contemplated in the framework would differ considerably from the FASB's current standard-setting role and responsibilities for U.S. issuers. Most significantly, the FASB would participate in the process for developing IFRS, rather than serving as the principal body responsible for developing new accounting standards or modifying existing standards under U.S. GAAP. The FASB would play an instrumental role in global standard setting by providing input and support to the IASB in developing and promoting high-quality, globally accepted standards; by advancing the consideration of U.S. perspectives in those standards; and by incorporating those standards, by way of an endorsement process, into U.S. GAAP. Additionally, the FASB would become an educational resource for U.S. constituents to facilitate the understanding and proper application of IFRS and promote ongoing improvement in the quality of financial reporting in the United States." Paper, p. 8.

[18] We note that the tenor of sentiment on the investor panel of the SEC's July 7, 2011 "condorsement" roundtable struck us as resignation rather than enthusiasm, coupled with a desire to "hedge" through the FASB the likelihood that U.S. GAAP would not prevail as the international accounting standard.

APPENDIX A
Financial Crisis Bank Impairment Metrics





Source: SNL Financial

For each reporting period, we assumed banks in the worst quartile had the highest NPAs, NCOs, and reserves, and that banks in the best quartile had the lowest NPAs, NCOs, and reserves. We also assumed banks exhibiting these characteristics would be relatively stable cohorts over time even though their constituent members may not be identical from period to period. Banks included are all banks and thrifts reporting at year-end 2010.

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