CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

February 13, 1976

Securities and Exchange Commission
500 N. Capitol Street
Washington, D. C. 20549

Gentlemen:

The Board welcomes the opportunity to provide its views on the "Interpretive Statement by the Commission on Accounting for Transfers or Exchanges in Non Arm's-Length Transactions."

The proposed Interpretive Statement is prompted by the Commission's concern for the integrity of the accounting for transactions in which a debtor transfers assets to a creditor for cash or in exchange for a reduction in the outstanding debt. It appears to be the Commission's view that such transfers are not "normal business transactions" because of the creditor's substantial interest in protecting or minimizing its losses on an outstanding debt and on this premise the Commission would characterize such a transaction as "non arm's-length."

The proposed statement further advises that if no active market exists for the asset transferred, fair market value must be estimated by other means. The procedure the Commission appears to prefer is a calculation that discounts to present value the estimated future cash flow from the asset, imputing an "appropriate" rate of return to the creditor during the estimated holding period.

The Board shares the view that, in accounting for "non arm's-length" transactions, great care must be taken to assure that the terms of the transfer reflect realistic values. However, the Board emphatically disagrees that the transfer of an asset from a debtor to a creditor for cash or in reduction of the debt constitutes a "non arm's-length" transaction merely because of the debtor-creditor relationship. Moreover, quite apart from this consideration, the Board takes strong exception to the proposed application of "present value" accounting techniques to commercial banks acting in their capacity as creditors.

It is normal business practice for a commercial bank to negotiate with a borrower for the purpose of protecting its position on a problem loan. To accomplish this purpose the bank may agree to restructure or extend the debt, to forbear in enforcing legal remedies against the debtor, or to take assets in reduction of the debt. Such a transaction should not be characterized as other than at "arm's-length" simply because of these circumstances. Under accepted definitions, a transaction is considered to be at "arm's length" if each party is able to distinguish its economic interest from that of the other party, and, where the interests conflict, each is able to choose the alternative that benefits it most. Only where there is a significant identity of economic interest between the parties to the transaction or where there is overlapping ownership or control -- in other words, where there may be self-dealing involved -- should a transaction be deemed to be other than at "arm's length".

Where the relationship between the debtor and creditor does not involve self-dealing and there is no such identity of interest, each will have an independent incentive to act in accordance with its own economic interest, even though the debtor may be in necessitous circumstances and the creditor may be motivated to minimize its losses. Neither party will be able to dictate the terms of the transaction, and each must negotiate terms in light of such considerations as the alternative of bankruptcy for the debtor and the responses that may be evoked from the creditors of the same debtor by reason of the transaction.

In any event, the Board believes that the "present value" method of accounting for such a transaction is not appropriate where the transferee is a commercial bank. To apply that technique in the case of a bank fails to take account of the fact that it is normally well within the capacity of a bank that has acquired assets in satisfaction of a debt previously contracted to carry those assets until market conditions permit a disposition under favorable circumstances. The Board is concerned that the imposition of "present value" accounting treatment upon commercial banks, as suggested in the proposed statement, could have significant adverse consequences for the banking system, both by causing widespread disruption of usual banking practices, and by deterring banks from arranging reasonable "work-outs" of problem loans.

The Board recognizes that in any case in which values are not readily ascertainable by reference to an active market for an asset, some alternate method of appraisal must be found. Where the creditor involved in an asset transfer is a commercial bank, the Board urges that any statement by the Commission emphasize the need for a "fair value" determination that takes account of many relevant factors, including, in particular, the bank's ability to hold the acquired asset for a substantial period, if necessary. Disparities between actual yields on such assets and "appropriate" rates of return will, of course, be reflected in the bank's income statements during the holding period.

As the proposed statement notes, the Financial Accounting Standards Board is currently considering the broader question of accounting for restructured debt, including the treatment of asset transfers such as those discussed herewith. We understand that the FASB has named a task force to study the question, and that three of the 16 members of that study group are bankers. The task force will thus be able to make comprehensive recommendations on this subject taking into account the wide variety of banking practices that could be affected by the application of "present value" appraisal techniques in loan work-out situations. We are concerned that a premature statement by the Commission may have the effect of pre-empting the FASB's consideration of the question. Accordingly, the Board questions whether issuance of an interpretive release at this time, either by the Commission or its staff, would be truly helpful to the financial community.

We appreciate having been given the opportunity to comment on the proposed statement and we would be pleased to discuss the matter further with the Commission if that would be of assistance.

Sincerely yours,

(Signed) Arthur F. Burns

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