



July 13, 2010

Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Golden:

Attached is a copy of the letter that The Clearing House Association L.L.C. ("TCH") recently submitted to the International Accounting Standards Board ("IASB") on its Exposure Draft ED/2009/12, Financial Instruments: Amortized Cost and Impairment.

As stated in the letter, TCH agrees with the IASB that the current incurred loss model is deficient and that a loss model should take into consideration not only events that have occurred, but also loss events expected to occur in the future based upon historical and statistical data. TCH also believes that an effective loan impairment model should be consistent with lending activities and risk management strategies of institutions and that an effective loan impairment model should include the following attributes: loans that are held for collection of contractual cash flows should be classified at historical cost adjusted for such items as unamortized premiums or discounts and that credit losses should be in a separate credit loss line within the income statement, separate from net interest income.

If you have any questions or would like to discuss this matter further, please contact me at 212-612-9216 (e-mail: henry.wysocki@theclearinghouse.org) or Gail Haas, Finance & Accounting Specialist, at 212-612-9233 (e-mail: gail.haas@theclearinghouse.org).

Very truly yours,

Henry V. Wysocki
Senior Vice President and
Senior Counsel

HVW:kp
Attachment



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Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street, First Floor
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Re: Exposure Draft on Financial Instruments: Amortized Cost and Impairment

Dear Sir David:

The Clearing House Association L.L.C. (“The Clearing House”), an association of major commercial banks,¹ appreciates the opportunity to comment on the International Accounting Standards Board (the “Board”)’s Exposure Draft ED/2009/12, *Financial Instruments: Amortized Cost and Impairment* (the “ED”), which proposes requirements for how to include credit loss expectations in the amortized cost measurement of financial assets.

Executive Summary

While The Clearing House appreciates the Board’s efforts to resolve this difficult yet important issue, we do not support the impairment recognition approach set forth in the ED, primarily due to its operational complexity, but also because we believe a model that commingles interest income and principal credit losses within net interest income does not improve financial reporting.

The Introduction to the ED indicates that the G20 leaders recommended that the Board take action “to improve and simplify the accounting requirements for financial instruments.” While there are conceptual merits to certain elements of the proposed approach, the ED would not, in our view, simplify the accounting for financial instruments. We also believe that the proposed approach would not provide more meaningful information to financial statement users. The Clearing House believes that there should be a simpler and more transparent way to improve the accounting model that governs the impairment of financial instruments. As described below,

¹ The members of The Clearing House are: Bank of America, National Association; The Bank of New York Mellon; Capital One, N. A.; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank, National Association; Royal Bank of Scotland N.V.; UBS AG; U.S. Bank National Association; and Wells Fargo Bank, National Association.

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The Clearing House believes that the model should be based on how an entity manages its business and should separate interest income from credit risk.

In spite of our objection to the overall approach set forth in the ED, The Clearing House supports the Board's proposal to replace the current incurred loss model with a model that acknowledges losses often emerge over a period of time -- therefore incorporating some type of expected loss concept has theoretical merit.² We agree that current incurred loss models are deficient in that credit losses are only recognized if there is objective evidence a loss event has occurred, and that loss event impacts the estimated future cash flows of the financial asset or group of financial assets and it can be reliably estimated.

The Clearing House also supports a model that does not include a probability threshold for recognition of credit losses. Credit losses under the current US GAAP incurred loss model are not recognized until it is probable a loss event has occurred and the effect of that loss event can be estimated. It is only after this probability threshold is crossed that banks are able to record a loss reserve. We agree with the Board's approach to avoid a model that inherently promotes a "cliff effect."

In lieu of current incurred loss models, we believe impairment measurement should take into consideration not only loss events that have occurred, but also loss events expected to occur in the future based upon known historical and/or statistical data. Accordingly, we believe the impairment allowance should at least equal the impairment calculated under an incurred loss model and potentially include an incremental component that considers some or all of the losses expected to emerge over the remaining life of the financial instrument but which have not been incurred as of the date of the financial statements. We agree with the Board that judgment must be used in the loss estimation process and that there must be a reasonable basis for quantifying losses expected to emerge in the future.

While we do not support all aspects of the proposed impairment model, The Clearing House does support the Board's determination that amortized cost is the most relevant form of measurement for certain financial assets. An amortized cost model provides information that is useful in understanding the business and identifying trends. However, the Board's approach to determining amortized cost by projecting future cash flows is overly complex. We believe the current methodology for determining amortized cost is well understood by both financial statement preparers and users and would not involve further changes to existing loan systems.

Rather than address individual questions contained in the ED, we have provided below a more detailed discussion of The Clearing House's objections to the impairment model set forth in the ED and a summary of our views on the ideal attributes of an effective loan impairment accounting model.

² Whether an expected loss concept should be based on the entire life of the financial asset, or some shorter period, is an issue where there are differing views among our members.

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Attributes of the Proposed Impairment Model Not Supported by The Clearing House

While we agree with the measurement objective of amortized cost and with projecting losses over a longer emergence period up to and including the expected life of the financial asset, there are several practical issues associated with the proposed impairment model that may negate these beneficial aspects. These attributes include:

1. Increased complexity for financial statement users

While certain members of The Clearing House believe the impairment recognition and measurement approach set forth in the ED is theoretically appealing, all members ultimately agree it is overly complex and does not accurately reflect the way banks evaluate credit risk and manage loan portfolios. The complexity for users is driven by the co-mingling of interest income and credit loss recognition in the blended effective interest rate proposed in the ED. This co-mingling has the potential to obscure the gross interest income and contractual yields earned on lending portfolios and the gross credit losses based on credit analysis, which are important parameters for users of the financial statements.

The proposed model also inhibits analysts and investors from evaluating the creditworthiness of the loan portfolio using traditional credit metrics and makes difficult any type of comparison with historical loan loss data that banks have accumulated over many years.

Additionally, it has been our members' collective experience that many financial statement users have limited understanding of the disclosures under US GAAP associated with purchased credit impaired (PCI) loans (which rely on a similar expected cash flow model). While users are familiar with the provision and traditional credit metrics such as nonaccrual loans and allowance coverage ratios, it would be difficult for many of them to understand the concepts embodied in an expected cash flow model that aggregates credit losses into the interest income line. The proposed approach would compound this difficulty in understanding by extending an expected cash flow approach to all financial assets accounted for at amortized cost, and increase the challenges of educating financial statement users and providing transparent disclosures to them in the notes to the financial statements.

2. Increased complexity for financial statement preparers

The proposed requirement to establish and monitor expected cash flows would almost certainly require the use of "closed" or "static" portfolios. In practice, loan portfolios are managed on an "open" or "dynamic" basis. Therefore, the need to define closed portfolios and regularly reassess expected cash flows to determine catch-up adjustments would be difficult to operationalize. Most companies do not have the data to support these estimated cash flows. In addition, it will be important to perform back-testing on the assumptions used. To ensure that back-testing is meaningful, it will be necessary to track different categories of loans at a sufficiently granular level to determine how expected cash flows for each category translate into losses. Additionally, most large financial services entities do not manage risk with this type of model because it does not provide relevant information.

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The proposed method is heavily dependent on long-term cash flow projections and relies on those projections to calculate the recognition of interest income and credit loss. Historical data, if available, will need to be adjusted to take into account current economic circumstances and expectations of the future. This will result in increased subjectivity, requiring greater judgment in assessing expected future credit losses. The cash flow models will require a set of assumptions that will inherently change from period to period and will likely introduce a certain amount of volatility that may not reflect the economics of the lending activities and the risk management strategies employed by the business.

Our members also believe it will be exceedingly difficult to (a) keep track at each reporting date of the original loss expectations (or portfolio of loans with common origination period and loss expectations), and then (b) determine in light of subsequent developments whether loss expectations need to be revised. In order to make the proposed method operational, the process will need to be automated and the loans will need to be grouped into portfolios.

The volume of disclosures will need to be expanded significantly to provide meaningful information on assumptions used in the cash flow projections. The volatility described above will also add to the complexity of the footnotes and may cause more confusion among financial statement users.

3. Pro-cyclicality

Catch-up adjustments required under the ED fail to address the countercyclical goals established by the G20 leaders. Any time the estimate of future cash flows changes as a result of a change in expected credit losses, an immediate credit loss adjustment would be required. The use of a catch-up adjustment intensifies cyclical changes in estimates as good economic environments lead to reductions in loss expectations while declining economic environments cause increases in loss expectations. As a result, the model proposed in the ED would not eliminate, but rather exacerbate, the pro-cyclical effect of credit provisioning in certain situations.

4. Potential for the allowance for loan losses to be less under the ED than under a US GAAP incurred loss model

If a credit loss is assumed to have been incurred in a portfolio of consumer loans, but the loss will take twelve months to be confirmed, the proposed ED impairment model would record the present value of that loss today, discounted at the loan's effective interest rate. In contrast, under a US GAAP incurred loss model for a portfolio of consumer loans, the undiscounted amount of the loss would be recorded, which may result in a greater allowance for loan loss than under the expected loss model. For losses that have been incurred, but not confirmed, most of The Clearing House members believe the amount of the allowance should at least equal the undiscounted amount of the incurred loss.

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5. Resource Costs and Risks

The impairment accounting methodology proposed in the ED for loans held for the collection of contractual cash flows has fundamental differences from the impairment accounting and risk management methodology for which existing systems were developed. As such, most current systems cannot accommodate the proposed approach and so, in order to systematize the new approach, significant capital investment would be required. It is not clear to us that the significant costs necessary to enable adoption of the proposed approach would be justified by the benefit, if any, to financial statement users.

Current systems are based on the amount of the borrower's unpaid principal balance and accrued contractual interest income, and are oriented towards the production of customer billing statements. The calculation and evaluation of credit impairments are largely handled outside the loan accounting system. The proposed model would require for our members the introduction of a second accounting system designed solely for the determination of impairment. The integration of these new impairment systems into the existing systems would be expensive and complex and subject banks to significant operational risk if manual processes are required as an interim solution.

Attributes of an Effective Loan Impairment Model Proposed by The Clearing House

Because of the conceptual and practical issues associated with the Board's proposed impairment model, we have developed a list of the attributes of an alternative model we believe would be conceptually superior to the Board's model, consistent with the lending activities and risk management strategies of financial institutions, and improve the transparency of financial statements. While our members vary in support of any particular model, we believe the model ultimately adopted by the Board should include the following attributes:

1. When the objective of an entity's business model is to hold loans to collect contractual cash flows, such loans should be classified at amortized cost.

For loans held for the collection of contractual cash flows, The Clearing House supports a recognition and measurement framework of amortized cost adjusted for impairment (i.e., the allowance for loan losses). In this regard, The Clearing House is contemplating a traditional view of amortized cost—historical cost (i.e., the principal amount of the loan) adjusted for unamortized premiums or discounts and net deferred loan origination fees or costs. The Clearing House believes the benefits of this approach are fundamental and numerous; the traditional amortized cost model is:

- Well-understood by both financial statements users (including bank regulators) and preparers;
- Relatively simple to administer operationally
- Conceptually consistent with the servicing of loans; and
- Representationally faithful, as portfolios of loans held for investment are managed for yield, not for capital appreciation or market returns.

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2. Preparers should not be required to project probability weighted cash flows in order to determine impairment or for income recognition purposes.

Under the current purchased credit-impaired loan accounting expected loss model in the US (SOP 03-3), entities are required to project cash flows in order to determine impairment and recognize interest income. While many agree this model has theoretical merit, it has been extremely difficult to operationalize in practice. Many of these difficulties revolve around the level of sophistication required to model, analyze and, in some cases, deconstruct and reconstruct cash flows on an ongoing basis. This process involves a significant number of estimates and judgments. Also, because the accounting model is decoupled from the actual application of principal and interest payments on the loans, it is extremely difficult to establish efficient and effective controls around the quality of the resulting accounting information. Further, the Board's proposal that banks execute multiple expected cash flow scenarios in order to achieve a probability weighted outcome would require extensive system retooling, with little benefit or improvement to financial statement users.

In general, our members' collective experience with expected cash flow models indicates pooling of loans is necessary in order to increase the reliability of the timing and amount of expected future cash flows. The number of pools required if this type of model were applied more broadly would likely be very significant and, therefore, the set up and monitoring of such pools would be an operationally intensive exercise. The loan systems of most financial institutions make it extremely difficult to produce probability weighted cash flows for loans on a pooled basis and, therefore, supplemental accounting systems may need to be developed to accommodate this requirement. Further, the proposed model essentially requires the use of closed pools in order to estimate cash flows. It would not be unusual for a large financial institution to have over 100 new closed pools each quarter. Thus, the operational complexity associated with maintaining these models would grow exponentially over time.

It is likely that adjustments recorded at a pool level may need to be pushed down to a loan level to meet certain regulatory or other reporting requirements. This would be a significant undertaking as banks' current loan systems cannot accommodate these changes easily. Assumptions about how to push the adjustments down to the loan level would also need to be made. All required systems development would be in addition to, not in place of, existing loan systems, since loan level record keeping would still be required for business purposes (e.g., loan servicing and customer reporting).

Furthermore, banks' credit loss forecasting processes are predominantly focused on estimating principal losses in their loan portfolios. These processes are not designed to dynamically forecast the amount or timing of future principal and interest cash flows over the lives of numerous loan portfolios. While margins are projected at a high level for business management purposes, the processes around these estimates would need to be significantly expanded and more robust to be relied upon for financial reporting purposes. Developing the capability to project, at the end of each reporting period, all future principal and interest cash

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flows for all loan portfolios over their entire lives would require significant additional data as well as systems capability. This would likely take the industry years, not months, to implement and it may never be possible to implement such requirements.

3. The allowance for loan losses should permit loss expectations for a longer period of time than the time period covered by the incurred loss model.

The Clearing House believes that the current incurred loss model should be replaced with a model that permits a longer emergence period, up to and including the expected life of the financial asset. We agree with the Board that the current incurred loss model is deficient in that credit losses are only recognized if there is objective evidence of impairment as a result of a loss event that has occurred and the effect of that loss event is probable and can be estimated. Instead, we believe that impairment measurement should take into consideration not only loss events that have occurred but also losses that are expected to emerge in the future based on historical data and observable indicators or trends evident in the current period.

We believe that this approach is conceptually consistent with the accounting for certain other types of loss contingencies. For example, consider a term life insurance contract in a case where the insured is young and healthy as of the balance sheet date. It would be inappropriate for the insurance company not to recognize any related mortality reserve. In fact, a mortality reserve is required because of the statistical chance that the then-healthy borrower will die at an early age due to a future accident or illness. Just because the probability is low does not mean that a reserve is not required.

In another analogous situation, manufacturing companies are often required to recognize statistically-determined warranty reserves when they sell their products. Although the company does not know which particular product units will prove to be defective, past history has demonstrated that the manufacturing process is not perfect and that some portion of the products that are manufactured and sold will be defective. Similarly, no bank has a perfect underwriting process. With a loan or commitment, the loss is unavoidable because the funds are in the borrowers' hands, or the bank is committed to lend to the borrower. In all cases, there is a statistical likelihood (sometimes small) that the obligor will default on the loan, and this exposure to loss exists at the moment the loan is made.

4. In measuring impairment, the model should permit preparers to consider expectations about events that are reasonably expected to occur "through-the-cycle," in addition to past events and existing conditions.

The Clearing House believes impairment losses should represent a statistically-based estimate of principal losses (i.e., credit losses) that consider the characteristics of the underlying loan, the estimated point within the current economic cycle, and both the visibility and reliability of forecasted macroeconomic data relevant to the performance of the underlying loans. Estimates of credit losses should reflect consideration of all significant factors that impact the collectability of individual loans in the portfolio. Existing incurred loss models cause reserves to be at their lowest level at the peak of a business cycle. As the

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growth portion of the cycle inevitably ends, banks not only face higher charge-offs, but are also effectively required to increase their overall reserve levels at a time when it is important to preserve capital. An appropriate impairment model would address this issue.

5. The allowance should be based on undiscounted principal losses only.

There are two components in the development of a life of loan allowance: 1) incurred loss portion and 2) expected but not yet incurred. For purposes of clarity, transparency and simplicity in financial reporting, a majority of The Clearing House members believe both components of the allowance should be based on undiscounted principal losses only. As further discussed below, it is operationally very difficult to combine and then somehow disaggregate the principal and interest cash flows of a loan for financial accounting and reporting purposes. Also, as discussed above, banks' credit loss forecasting processes are predominantly focused on estimating principal losses. In fact, the propensity to equate credit losses with principal losses is a concept that is deeply ingrained in the thought processes of most credit professionals and many financial statement users (including regulators), particularly in relation to loans measured at amortized cost. It would be extremely difficult for many of these stakeholders to understand and/or embrace a model where foregone interest only, or a delay in the timing of scheduled principal payments, would trigger the recognition of a credit loss. For these reasons, The Clearing House believes any revised loan impairment model should include both incurred losses and an amount attributable to expected but not yet incurred losses and that this model should be based on undiscounted principal losses and consider all available evidence, both positive and negative, to support the forecast of expected losses.

6. The geography of impairment recognition should improve transparency.

In order to improve the transparency of financial reporting, The Clearing House believes that credit losses should be recognized in a separate 'credit loss' line within the income statement, which would be reported separately from net interest income. Impairment charges would be recorded as a contra-loan asset on the balance sheet, but would be separately disclosed. This methodology is necessary for understability of a bank's financial statements. Although the proposed and existing IAS 39 guidance require the separation of effective yield and, in the former case, the initial estimate of expected credit losses from ongoing credit losses, the effective yield calculation in both cases naturally includes an element of credit losses as it is based on the net carrying value of the loans rather than par. It has been our members' experience that analysts and investors find a separate disclosure of credit losses to be more meaningful, because it provides them with information to better estimate bank earnings under various scenarios including a deteriorating or improving credit environment. The recognition of both impairment and interest income in one line item defeats the objective of increased transparency that is achieved when they are disclosed separately. Finally, the presentation of impairment within interest income runs counter to the credit disclosures that many preparers are currently required to provide and financial statement users are accustomed to using.

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7. The model should not continue the pro-cyclical aspects of the current incurred loss model and should have a methodical way to build and release the allowance for credit losses.

Both the current incurred loss model and the Board's proposed expected loss model are pro-cyclical in that they require banks to record subsequent changes in expected losses due to a deteriorating credit environment in the period the potential for future expected losses is identified rather than over the remaining life of the portfolio. Most of The Clearing House members support the aspect of the Board's model which does not require the immediate recognition of losses expected to emerge over the portfolio's remaining life but that have not yet been incurred. We see no conceptual difference between the Board's approach of spreading the initial recognition of losses over the portfolio life and our proposed approach of potentially including an incremental component that considers some or all of the losses expected to emerge over the remaining life of the financial instrument. The ability to build and release loan loss allowances over the life of the portfolio in a methodical way would reduce pro-cyclical volatility and will insure a steady flow of credit to the capital markets.

Conclusion

In summary, our proposed attributes of an alternative model are consistent with the Board's proposed model in that both are based on expected losses. However, whereas the Board's proposal would develop expected losses based on projected cash flows, the attributes of an alternative model that we would support would develop expected losses based on historical loss experience and observable indicators or trends evident in the current period. These expected losses would be identified earlier than under an incurred loss model, but would not exceed expected lifetime losses of the portfolio. We believe that the attributes of the model described above would be easier for banks to apply, easier for the users of financial statements to understand and would be consistent with the strategies and methodologies that banks use to evaluate and manage credit risk.

Lastly, The Board has now issued two of three phases of its Financial Instrument project. An exposure draft for the final phase on hedge accounting is expected to be issued in the third quarter of 2010. This project has followed a piecemeal approach, particularly when compared to the FASB's Financial Instrument project. We urge the Board to consider extending the deadline for the ED (or allowing an additional comment period) in order to permit companies to comment on all three phases of the IASB's financial instruments project in an integrated approach. This extension would also permit companies to perform a comprehensive review of the FASB's Financial Instruments recommendations and be able to provide comments to the IASB on both models based on additional insight gained during that review.

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Thank you for considering the comments provided in this letter. If you have any questions or are in need of any further information, please contact Henry V. Wysocki, Senior Vice President and Senior Counsel at (212) 612-9216 (henry.wysocki@theclearinghouse.org) or Gail Haas, Finance and Accounting Specialist, at (212) 612-9233 (gail.haas@theclearinghouse.org).

Very truly yours,



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