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Comment Letter No. 143

American Bankers Association
Building Success. Together.

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Leslie Seidman, Chairman
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Via email: director@fasb.org

RE: IASB Supplemental Document: *Financial Instruments: Impairment*
FASB File Reference No. 2011-150 *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment*

Dear Sir David Tweedie and Chairman Seidman:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Supplementary Document *Financial Instruments: Impairment/Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment* (SD). ABA brings together banks of all sizes and charters into one association. ABA represents banks of all sizes and charters and is the voice for our nation's $13 trillion banking industry and its two million employees. The majority of ABA's members are banks with less than $165 million in assets. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities.

As we mentioned in our letter dated March 11, 2011, ABA supports the efforts of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to pursue changes to the impairment models initially proposed by the Boards. We believe that the FASB, IASB, the banking regulators, and ABA have the same goal: to get the accounting right and be responsive to the needs of the many users of bank financial statements, as well as implement an impairment model that is operational for preparers. We also encourage the Boards to continue to work toward a converged solution for impairment.

We believe that the SD has achieved a useful purpose – to begin the in-depth discussions that needed to take place, both from a conceptual perspective and from a more detailed perspective. Because there is much that was not addressed in the SD (such as which assets would be covered by the SD, how single assets would be treated, how troubled debt restructurings would be addressed, income and other measurement issues, etc.) and because the SD is unclear in material applications (such as the definition of "expected loss", how "average life" would be applied, etc.), it is difficult for us to provide the Boards with sufficient detailed guidance with regard to the SD. Additional structure needs to be applied to the framework, and we are glad to work with you to help in this effort so that we may provide you with better information as to our industry's views. At this point, we can provide broad feedback on the SD and information about the direction that we believe should be taken.

Most of our members who have been involved in our discussions on the SD do not support the combined model and do not support the "time proportionate" approach. Although there are many questions and concerns about the "foreseeable future" approach, it is more closely aligned with the direction we believe should be taken. We believe that building on the current model, which the "foreseeable future" approach appears to do, is preferable to the "time proportionate" approach. Building on the current model has been our most recent focus, attempting to make improvements to it rather than uproot it. In this comment letter, we will provide some additional thoughts about an approach that we have been considering and we encourage the Boards to consider this approach as you move forward with this project.

As requested in our letter to you dated March 11, 2011, additional time is needed for all parties to consider how to best resolve this issue. In the meantime, we urge you to consider the following:

- Simplicity – Because this is such an important component of banks' financial statements, we need to be able to explain the accounting and how it relates to loan quality and performance.
- Convergence – One converged, high quality standard is preferable.
- Exposure – The SD does not include some of the essential guidance that is typically provided in an exposure draft. When further tentative decisions have been made by the Boards, additional exposure for comment will be needed.
- Field testing – Adequate field work is needed so that large and small banks can test and provide feedback to the Boards.
- Timing – Sufficient time needs to be provided to commenters during the next stage of proposal, for field testing, and for lead time for implementation.

Comments on the SD

Some of our broad concerns about the SD are:

- Newly-introduced concepts are vague and confusing to both preparers and users.
- More time is needed and field testing is necessary before any decision is made.
- The impairment model must be relatively easy to explain.
- Existing accounting principles should be modified, not abolished.
- Measurement of expected losses must be addressed.
- Significant issues with the proposed model need to be addressed.

Newly-Introduced Concepts are Vague and Confusing to Both Preparers and Users.

Our hope is that we can work with both Boards to develop principles with sufficient clarity so that there is a common understanding among all involved, the standard can be applied as uniformly as possible on a global basis, and the standard can be easily understood by users of financial statements. Although we acknowledge that both the IASB and the FASB have worked very hard to develop a proposed standard, we do not believe the SD meets these objectives. Instead of an impairment model that is understandable and can be uniformly applied, the models establish new concepts that are unclear, open the door to wide interpretation, and blur the results to the user.

The SD represents a fairly dramatic shift in estimating credit losses. Introducing a new impairment model that is not built on clear key definitions invites both confusion and concern that different users, regulators, and auditors will interpret a final standard. Indeed, during certain conference meetings of the two Boards as well as discussions with staff, clarification on certain parts of the SD have either been unsatisfactory or appear to conflict with earlier statements. Further, investors are often unclear as to what they prefer to be recorded in the financial statements, and discussions with certain regulators indicate a difference in understanding of how the proposed model will be implemented, compared to the understanding by bankers.

In both of the original exposure drafts, the boards moved in a direction that is consistent with the recommendations of groups that studied the financial crisis. In short, these groups criticized the current incurred loss model as producing allowances for loan losses that are "too little, too late" – and recommended that allowances be more "forward looking". The models proposed in the SD addresses some of the key operational problems with the original proposals. However, as we have worked our way through the SD, it has become clear to us that the SD introduces too many new concepts and abandons too many solid principles that are currently in effect. In essence, we are concerned that it will guarantee confusion for years to come, especially in a time when confusion among financial intermediaries should be avoided. The world banking system is too important to allow this.

More Time is Needed and Field Testing is Necessary Before any Decision is Made.

It is critical for bankers, regulators, investors to be in agreement as to an impairment model, but the sixty day comment period is not nearly enough time to come to agreement or to provide an appropriately educated and thoughtful response – especially as the comment period coincided with preparation of year-end financial statements. The SD focuses solely on "open" portfolios and excludes measurement. Thus, it does not address many components of impairment that need to be evaluated together. Therefore, our response reflects our thoughts thus far. Though they result from numerous calls and meetings with bankers at institutions of all sizes, our views could change as we progress through the remaining issues that were not addressed in the SD. Additionally, views about any proposed model could change significantly based on the findings of field testing. Some of the important related issues include:

- Recognition of losses of closed portfolios
- Recognition of losses of individual assets

- Recognition of losses of purchased (including both credit-impaired and non-credit-impaired) loans
- Applying these models to debt securities
- Treatment of loan modifications currently classified as troubled debt restructurings

From our perspective, decisions on such significant issues would normally go through a formal exposure draft process. Given these issues are still outstanding, we encourage the Boards to work together to issue a converged and comprehensive proposal on impairment with sufficient time for comments and field testing. Impairment is a critical measurement in the banking industry for both public reporting and for safety and soundness purposes. Therefore, any changes must be subject to comprehensive and intense scrutiny from the various interested parties.

The Impairment Model Must be Relatively Easy to Explain.

Most of our members believe the proposed model is too complicated. As noted below, the proposed model introduces new concepts that are cumbersome and difficult to explain to the various stakeholders of a banking institution. The requirement to perform a "good book" calculation each quarter for the foreseeable future and another for the life of the portfolio – of which one will eventually not be recorded – may be possible to put into operations, but it puts an unnecessary burden on institutions in completing their quarterly financial reports. Explaining to investors how certain "good book" portfolios change between the time-proportionate allocation and the foreseeable future will then further blur what is inherently an estimate based on many moving parts. Expounding on what is included in the "good book" will also require significant time, since each company will have its own method. Finally, illustrating how prepayment rates and new business impact the final allowance will detract from the real issue: impairment of a loan. The time to document and audit the estimates related to these new concepts, as well as the risk of disagreements about their meanings, adds significant burdens for all parties without necessarily improving the accounting.

Rather than uproot the existing model, many of our members believe that appropriate improvements can be made to the current impairment model by merely requiring more "forward looking" aspects of the process, as well as accepting the highly-judgmental nature of the process.

Existing Accounting Principles Should be Modified, Not Abolished.

ABA supports the implementation of loan loss allowance methodologies that are more "forward looking" than a strict reading of the current U.S. standards might allow. In our opinion, however, a whole new concept of "expected losses over the remaining life of the pool" (ELLP) is not necessary, and this concept is the foundation underlying much of the confusion surrounding the SD. While theoretically sound from a business management perspective related to many portfolios of large banking institutions, ELLP could open a "Pandora's box" of issues, requiring new terms such as "good book/bad book", "open portfolios", "foreseeable future", and "time proportionate allocation". For the vast majority of bankers in the United States – those who run community banks, regional banks, and many parts of large banks – these terms mean nothing. Worse, ELLP is applicable only to loans managed in open portfolios, so these bankers are skeptical of what will be required to measure and record

allowances for other loans. To them, the important information is whether loans on the books today will or will not be collected. Although this is not a science, many of them are concerned that ELLP introduces confusion, and its accompanying terms further blur what the allowance and impairment represent.

With that in mind, most of our working group members believe that the new model should be built upon the existing models. Using IFRS as an example, International Accounting Standards No. 39 (IAS 39) could be amended and not altogether scrapped. Changes to IAS 39 might include the following:

- Events alone do not necessarily cause losses. Losses, and the severity of such losses, may also result from micro- and macroeconomic conditions that may not have direct impact on a specific borrower.
- Impairment losses or improvement in an impaired asset may then result from likely future events and conditions.
- Impairment losses need not result if, and only if, there is objective evidence that a loss event has occurred. The trigger of a loss event is unnecessary, and subjective evidence (which includes internal analysis used by management) should also be allowed.

These suggestions reflect what many believe is applied in actual practice today at many U.S. institutions, as usage of tools such as historical loss rates and migration analyses are primarily focused on the eventual charge-off as a proxy for the precise identification of the specific loss event. More importantly, however, these changes help address the "too little, too late" weaknesses of the current incurred loss model that have prevented full forward-looking allowances. Expounding on these concepts will enable banks to record allowances related to these issues sooner and more fully than the current framework allows. From a practical perspective, these changes will enable (and often require) banks to analyze the following forward-looking factors:

- National or local economic conditions that are expected to improve or deteriorate based on historical business cycles.
- Borrower or industry-specific conditions, including the impact of internal operations, the competitive environment, and legal and regulatory environments.
- Underwriting assumptions on products that indicate different loss emergence or severity patterns than can be supported by observable historical data.
- Global or national economic conditions, as well as financial conditions or activities of specific entities that may result in increased or decreased availability of liquidity or credit, whether to specific borrowers or to the economy in general.

Measurement of Expected Losses Must be Addressed.

The biggest challenge in evaluating the models discussed in the SD is doing so without understanding the Boards' expectations on the measurement of expected losses. Bankers are concerned that the lack of more definitive measurement guidance for expected losses will result in a lack of comparability among institutions, depending upon how the various institutions, their regulators and their auditors define expected loss.

During some of the Board meetings, it was noted that peer data should be utilized to determine expected losses for smaller institutions. While initially appealing, this approach, in the context of the proposed model, opens issues that are fraught with questions that will likely be answered by local regulators or auditors, resulting in a wide divergence in practice. Bankers believe that even if peer loss data is agreed upon, the amount of historical loss data that will be utilized will be subject to enormous interpretation. For example, expected losses based on historical losses covering a full business cycle will often be dramatically lower than those derived using the most recent three years. While this difference may "even out" over time, it makes one question the usefulness and the reliability of the information at a specific point in time. In times of economic stress, such information may also prove to be irrelevant, since, in the constructs of the proposed model, the losses expected in the foreseeable future are likely to be the amount of the allowance actually reported on the balance sheet.

Reliance on peer data also penalizes many, if not most, institutions, since existing institutions normally have different underwriting standards (and, thus higher or lower loss rates) than those reflected in average loss rates. Adjustments made to the averages will, nevertheless, be difficult to quantify. Therefore, many bankers believe that auditors and examiners will merely require the average loss rates to be used. While this often occurs in current practice as it relates to estimating losses in the current model, the amount of the losses is magnified as they are estimated over the life of a portfolio. Most banking institutions in the U.S. have neither the experience in estimating losses over a period greater than three years, nor any systems to assist in reliably estimating losses over a longer time period. Therefore, bankers generally believe that peer data will be the de facto default used in the vast majority of cases. We question the reliability and relevance of information that shows everyone with similar expected loss rates.

There has also been discussion in Board meetings related to basing expected losses on pricing. While operations in some large banks may afford such estimates, for the vast majority of community banking institutions, proposals on loan pricing are submitted on a competitive basis that often ignores specifics of credit spreads. With this in mind, we recommend that if the proposed model is retained, more implementation guidance needs to be provided to enable banks, large and small, to estimate expected losses over the life of an open portfolio in a reliable manner.

Relating to measuring losses in the foreseeable future, the open-ended length of time to which the foreseeable future extends opens up many questions as to reliability. Based on discussions with our working group, most U.S. banks cannot accurately estimate losses past one to three years, with the time variations dependent on the type of product and credit characteristics of the portfolio. Many banks believe that these periods of time, however, can be significantly reduced in stressful economic times because of the uncertainty inherent in such times. While we do not advocate specific rules to be developed, we recommend that there be roundtable discussions among the Boards, regulators, auditors, and bankers prior to the issuance of any final standard related to possible boundaries on the length of this period.

Significant Issues with the Proposed Model Need to be Addressed.

Many of our members believe the proposed model fails to pass four minimum criteria that are critical in gaining acceptance from preparers and users of bank financial statements:

1. The proposed model requires estimates of expected losses over the life of an open portfolio – a measure that most banking institutions have no current capability to reliably estimate. As noted above, for most banking institutions, the lack of capability to estimate losses past a period of one to three years (depending on the portfolio characteristics) will force most banks to use peer data which is normally not reflective of individual bank underwriting. Therefore, banks believe these estimates to be unreliable, especially as new products are introduced in local areas.

2. The proposed model introduces concepts that are both foreign to users of financial statements and invite significant inconsistency in application between companies and reporting jurisdictions:

    a. The SD introduces the concept of the "good book" vs. the "bad book". While many can point to current GAAP's "FAS 5 vs. FAS 114" breakout, the SD breakout is not well defined and leaves the breakout to the credit risk management system of the individual company. Based on current international differences in the understanding of the definition of an impaired loan, the "good book/bad book" definition may only makes the situation worse. Comparability among banks may be lost. Therefore, if a "good book/bad book" concept must be retained, we strongly recommend that it be defined within the current GAAP concept of an impaired loan – the "bad book" would consist of impaired loans.

    The proposed "good book/bad book" breakout also presents a practical challenge for banks and the users of their financial statements. In current practice, in addition to the breakout between impaired and non-impaired loans, there is often a "third book" of classified non-impaired commercial loans. These loans are often segregated and allowances are provided based on classification and a factor that considers prior historical experience with similar loans. Under the proposed model, however, it appears that allowances on these loans are either amortized (if still in the good book) or (if in the bad book) assigned either a total loss or no allowance at all (due to the "all or nothing" nature of the loss). .

    b. The SD introduces the concept of "foreseeable future" to loan impairment. This term is not necessarily problematic; however, based on discussions with Board staff, bankers, and regulators, as well as in the ED, the term is subject to broad interpretation. For example, if an institution prepares a forecast which includes an estimate of losses for a 10 year period, will that be viewed as the "foreseeable future" even though the confidence level relating to those losses is very low? For practical reasons, we recommend that the Boards consider guidance which effectively limits the length of the foreseeable future.

We also believe the length of the period can vary, based on the status of the economic cycle.

U.S. Bankers Generally Prefer to Improve the Current Model.

As we noted above, bankers want any impairment model to be relatively easy to explain. Overall, we believe that the current impairment model – as is currently practiced in the U.S. – needs improvement. However, the needed improvement is to provide "forward-looking" allowances and not to totally change what the allowance represents. Because of the additional complexities introduced in the proposed model, we do not support the model as presented. Although much is not yet clear about how the "foreseeable future" model would work, it appears to be more closely aligned with current impairment concepts, and most of the U.S. bankers that have been involved in our working group would prefer the "foreseeable future" model over the "time allocation" model. This preference assumes that there is sufficient modification to the language to ensure that estimates made under such a model retain a level of sufficient reliability that is totally lost under an ELLP methodology. Further, this preference also assumes that there is language to allow preparers to consider both future economic events and conditions and certain subjective internal analysis to be used in estimating losses.

As you will see from the comment letters, our members have different views about what the most appropriate model should be:

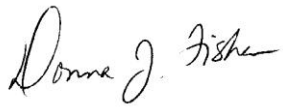
- Many want international convergence, with some believing strongly that international convergence is important. For others, international convergence is less important.
- Most of our working group does not support the SD or the time proportionate model, though there are some that do support it.
- Most seem to want to build on the existing model rather than change to an entirely new and more complicated model.
- Most bankers have not had a chance to focus on the SD or what the proposed model should be.

In an effort to begin the discussion on how to build on the current model, our working group (which includes representatives from approximately 70 banks of all sizes) has agreed to include in this comment letter a proposal that should be considered. (See Appendix A) A vast majority of the banks in our working group support the framework in Appendix A. Because of this largely positive feedback and because the working group represents all sizes of banks, we believe the proposal would receive broad industry support. We are including it in order to provide the general direction that many of our members believe the Boards should take, as well as concepts the Boards should address. We look forward to discussing this with you, along with any other views you receive.

We recognize that developing a global standard for accounting for impairment is a very difficult task, and we appreciate the effort and priority that the Boards have placed on this issue. We also appreciate the significant amount of outreach that the Boards have done with the ABA, and we want to continue this effort to develop a high quality standard that can be supported and applied consistently around the world.

Thank you for your attention to these matters. On the following pages, we have responded to the questions posed in the FASB's SD. Please note that we are somewhat hesitant to provide these responses, as they have been developed within a comment period that has afforded little detailed examination by most bankers. Please feel free to contact Mike Gullette (mgullette@aba.com; 202-663-4986) or me (dfisher@aba.com; 202-663-5318) if you would like to discuss our views.

Sincerely,



Donna J. Fisher

Responses to Questions Posed in the Supplementary Document

Question 1: Do you believe the proposed approach for recognition of impairment described in this supplementary document deals with this weakness (i.e. delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

> **ABA Response:** Removing the incurred loss concepts from the impairment framework and allowing entities to consider current conditions as well as future events and economic conditions are the most significant steps in avoiding the delayed recognition of expected credit losses. As it relates to the proposed model, we believe the floor of the expected credit losses in the foreseeable future is the aspect of the model that specifically deals with the delay in recognition of expected credit losses. However, we believe that the "greater of" aspect of the model is cumbersome and confusing if the intent is to address the delayed recognition of expected credit losses.

Question 2: Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

> **ABA Response:** ABA supports simplifying the process as much as possible. We have not yet had the opportunity to discuss how the SD might apply to assets other than open portfolios.

Question 3: Do you agree that for financial assets in the 'good book' it is appropriate to recognize the impairment allowance using the proposed approach described above? Why or why not?

> **ABA Response:** We believe the "greater of" provision of recognizing impairment in the "good book" makes it unnecessarily difficult for banks to explain the meaning of the provision or the allowance to most users of the financial statements. This difficulty, based on whether the time-proportionate allocation (TPA) is used or the foreseeable future (FF), is magnified as different portfolios go in and out of the TPA method. We also believe that the cumbersome nature of calculating losses both on a TPA and an FF basis is superfluous.

Question 4: Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

> **ABA Response:** We believe determining the impairment allowance on a TPA method will be time consuming for many banks. The difficulties for many smaller banks to determine the expected life of the good book loan portfolio, as well as the time to audit that estimate, will be overly costly. Currently, portfolio expected life calculations provided to many community bankers for asset/liability management purposes do not fully consider credit losses. Further, most bank lending systems do not maintain the initial lending dates (as opposed to renewed). Determining the age of draws on revolving lines of credit poses further challenges.
>
> Questions also remain on the accuracy of the underlying TPA method assumption that the longer a loan is outstanding, the more likely there will be credit loss. However, even if the TPA can be efficiently performed, bankers may struggle to reliably estimate expected losses over the lives of portfolios. In

actual practice, credit loss assumptions are not always directly factored into the interest rate of the note. The rates are often determined through competitive bidding processes.

For most banking institutions, peer data is also inappropriate to estimate expected life of loan losses. In addition to individual product differences and geography, bankers believe that they will be forced to record their expected losses based on arithmetic means or medians that do not reflect the quality of underwriting by their individual institutions. In other words, bankers believe that, using peer data will put their banks at a disadvantage. With this in mind, many bankers do not believe estimating a life of loan portfolio loss to be operational.

Question 5: Would the proposed approach provide information that is useful for decision making? If not, how would you modify the proposal?

ABA Response: Bankers are struggling on how to explain the results of the proposed model, especially as changes between TPA and foreseeable future occur through time and between different portfolios. Bankers understand the allowance as the amount of losses that management believes to be inherent within the portfolio of loans currently held. The TPA method does not provide this answer.

Question 6: Is the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

ABA Response: Introducing terms "good book" and "bad book" adds confusion since institutions already use the concepts of performing and nonperforming (or impaired) loans. The proposed definition of 'bad book' will lead to varying interpretations and inconsistency among entities and among countries. If a bad book concept is to be maintained, we believe the definition of a bad book loan should be in accordance with that currently in GAAP for an impaired loan.

It is unclear how loans that are currently unimpaired, yet classified for regulatory purposes, should be accounted for. Currently, these loans are often segregated and a factor is applied to estimate an allowance. This factor is generally based on historical experience of these kinds of loans in this classification. Maintaining them in the good book does not appear appropriate, since the higher risk indicates that estimated losses should not be amortized. However, as we understand the model, estimating an expected loss would result in an "all or nothing" scenario, due to the nature of these loans. Neither of these results appears reasonable. Therefore, more guidance is required to address these situations.

All this is compounded by the fact that purchased credit-impaired loans are often managed neither strictly to collect principal and interest nor to recover the asset. Since they are often acquired at significant discounts, asset recovery is not necessarily the objective of all workout or modification processes performed by the entity.

Question 7: Is the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

> **ABA Response:** As proposed, the requirement to differentiate between the two groups will be difficult to implement, since the 'bad book' differs from the definition of an impaired loan, which is a relatively objective concept and has general understanding in the U.S. Since the bad book is based on an institution's credit management policy, if any, the audit process may be inefficient.

Question 8: Do you agree with the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

> **ABA Response:** The distinction of a good book vs. bad book is appropriate under current GAAP. However, until more guidance can be given on how expected losses are measured on the bad book, we cannot comment on how appropriate it is under the proposed model. For example, as noted in the response to question 6, we do not believe an expected cash flow analysis (such as those currently performed for individually impaired loans) would be appropriate for many non-impaired commercial loans that are classified (e.g. special mention). Non-impaired special mention loans are more appropriately grouped together (based on characteristics of the portfolio), with expected losses estimated based on factors such as historical averages, etc., also taking into account qualitative factors. We believe that these loans may fit into a "third bucket" since estimated losses should neither be amortized nor immediately provided for, due to the unreliability of the estimate for such loans.

Question 9: The Boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this proposed model. Specifically, on the following issues:

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?

> **ABA Response:** If implemented as designed, many banks believe the floor may not be necessary, as the TPA method may be the general rule in practice. However, issues regarding unreliability of the expected loss over the life of the portfolio, as well as the average expected life itself, will often result in insufficient reserves in times of stress and over-reserving in times of economic expansion. In other words, they believe both the expected losses and expected life in a TPA method will change infrequently. But when they do, it will likely be too late and may result in a procyclical cliff effect, as expected losses are increased and expected lives simultaneously decreased.
>
> Further, unless there is more guidance provided, there may be certain situations in which, in practice, the TPA method may provide insufficient, counter-intuitive allowances. For example, for products that have losses that occur early in the expected lives, charge-offs taken in the bad book may cause negative good book allowances, as the good book takes only a proportion of those losses. In other words, recording the proportion of expected total loss may reduce

the current loss to an amount lower than what has been realized as an actual charge-off. Adding to that, using some sub-prime loan products as examples, unless there is more clarity as to what must be placed in the bad book, impairment will often be amortized on good book loans, though there are impending losses due to contractual payment increases. We believe these situations will be unacceptable to users of financial statements.

(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?

ABA Response: A floor that is required only in certain circumstances will be confusing to both preparers and users of financial statements. While this idea is appealing, determining whether a loan product has an appropriately early loss pattern will be challenging to most banks and most auditors.

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

ABA Response: This is a difficult issue to address. Bankers generally agree that estimates of losses beyond most types of loans cannot be foreseen beyond two years. For some types of loans, the period is shorter, and for others the period could extend as far as three years. Thus, for practical purposes, the foreseeable future should be defined so that a maximum period of three years is provided. However, there should also be the understanding that, depending on uncertainty based on the status of the economic cycle, this period can decrease. Further, it should be noted that the period is expected to vary based on loan type and credit characteristics of the portfolio.

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

ABA Response: As noted above, many banks believe the length of the foreseeable future period will vary by product type and other characteristics in the portfolio and will fluctuate based on the economic environment. In an expanding economy, the foreseeable future would be expected to increase and in times of economic stress, the foreseeable future would decrease due to increased uncertainty. With this in mind, however, we understand that the size of the allowance would still typically be larger during times of economic stress than in economic expansion.

(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response: including details of particular portfolios for which you believe this will be the case.

ABA Response: Bankers believe that the foreseeable future period for consumer loan portfolios will generally be around 12 months (though there are some who believe this period may be longer) and the foreseeable future period for commercial loan portfolios will typically be from 1-3 years, depending on the nature of the product and economic environment.

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognized under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

ABA Response: Banking institutions have not been able to reliably estimate losses more than three years for certain commercial portfolios. For consumer portfolios, this amount is approximately one year.

Question 10: Do you believe the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details or particular portfolios for which you believe this will be the case.

ABA Response: Rough calculations based on industry-wide loss data indicates that over the past ten years, the foreseeable future floor would be recorded in times other than periods of significant economic expansion. With this in mind, since it is difficult to understand how the good book/bad book split is determined and how expected losses are to be determined, we do not believe the results just noted are necessarily indicative of what would actually occur. In other words, during the time period provided, reliable testing has not been performed. This problem is further compounded by the unknown effects of regulatory capital adjustments that have been proposed, as well as how other regulatory requirements (Dodd-Frank Act, for example) will impact the overall economy.

Question 11: The Boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the proposed approach described in paragraph B8(a)? Why or why not?
(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

ABA Response: ABA disagrees with allowing any flexibility to discount loss estimates. The provision for loan losses should address only principal losses. Any flexibility to discount loss estimates will be confusing to both management and investors of banks who understand the concept of principal losses and are seeking comparability.

Question 12: Would you prefer the IASB's approach for open portfolios of financial assets measured at amortized cost to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the IASB's approach (i.e. to recognize expected credit losses over the life of the assets)? Why or why not?

> **ABA Response:** The IASB approach is preferable to the proposed model, merely because it eliminates the two-step "greater of" process to determine good book allowances. However, as noted above, the TPA method is problematic because of the requirement to estimate losses over the expected life of the portfolio and to estimate ages of portfolios, as well as expected lives of portfolios on any reliable basis. U.S. bankers generally prefer to build on the current accounting model rather than follow the TPA method.

Question 13: Would you prefer the FASB's approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the FASB's approach (i.e. to recognize currently credit losses expected to occur in the foreseeable future)? Why or why not?

> **ABA Response:** Based on the limited review that has been performed, ABA prefers the FASB's approach, as it appears to build on the current model. However, more definition around "foreseeable future" is needed. We believe the FASB's approach is simpler to operationalize and to explain to bank management and investors. We believe that it provides the basis to amend, and not to totally discard, current GAAP and IFRS, which is preferable to the models in the SD.

APPENDIX A

Discussion Paper: Credit Impairment Model Proposal

Introduction

The incurred loss model under U.S. GAAP and IFRS that governs credit impairment has been criticized following the recent financial crisis. The two main criticisms raised are: 1) reserve adequacy (i.e., credit reserve levels at the inception of the financial crises were inadequate to absorb the elevated losses that occurred during the crisis and likely substantially existed at the inception of the crisis) and 2) timing of recognition (i.e., increases in realized losses led to a combination of elevated charge-offs and large reserve builds at the peak of the crisis that inappropriately reduced market confidence in the banking sector). Many believe the delayed timing of loss recognition and magnitude of loss, which together reflected a severe and rapid deterioration in credit quality, exacerbated the severity and length of the financial crisis. All parties (standard setters, regulators, investors, and preparers) agree that improvements to the credit impairment guidance are necessary.

We believe that the fundamental principles inherent in the incurred loss model are sound and have served the industry, regulators and financial statement users effectively by providing a well understood framework to determine credit-related allowances. However, over time, the incurred loss model has increasingly been interpreted in a way that has resulted in a significant flaw: allowance calculations based on too narrow a view of the credit cycle. History has shown that the credit profile of financial instruments is highly cyclical, typically with a period of benign loss activity that coincides with the expansion and peak of overall economic activity and credit availability, followed by a shorter and more concentrated period of elevated credit losses. Narrow interpretations and application of the incurred loss model result in the compression of this cycle by considering only losses estimated over an abbreviated loss emergence period and restricting the use of market trends and other data that would indicate changes in the probability or severity of loss until such deterioration is observable.

The events of the recent financial crisis put a spotlight on this weakness in the application of the incurred loss model, resulting in the criticism noted above. Although we believe the fundamental principles of the incurred loss model remain sound, some thoughtful and tailored changes are necessary to incorporate the cyclical behavior of financial instruments and lack of transparency around inherent losses prior to the deterioration of the credit environment.

To date, the independent proposals from the FASB and IASB have focused primarily on only one aspect of the problems with the current model. The FASB's "foreseeable future" model addresses reserve sufficiency through expansion of the loss definition and the time period covered by the forecast by removing the "probable" trigger and expanding the types of inputs that may be considered in a loss forecast. However, the foreseeable future model suffers from the same flaw as the existing model, as it may be narrowly interpreted with a limited view of both the losses within the emergence period and of breadth and depth of the credit cycle. Accordingly, we believe the "foreseeable future" methodology, as originally proposed, may not adequately address the weaknesses in the current model and may perpetuate and exacerbate the pro-cyclicality of results while only modestly increasing the absolute level of credit reserves during extended periods of benign credit activity.

Also, recent banking regulator comments lead us to believe this model, if adopted globally would potentially be implemented differently in the U.S. (most likely with longer "foreseeable future" loss forecasting periods) than in other jurisdictions.

In contrast, the IASB attempted to address the relationship between credit losses and loan pricing and income recognition and, therefore, pro-cyclicality, by introducing a time-proportionate spreading of credit losses over the expected life of the portfolio. However, this model does not result in a credit reserve that is sufficient to anticipate significant changes in credit loss curves as it also may focus on a narrow view of the credit cycle. Accordingly, the original IASB approach also perpetuates pro-cyclicality as changes to originally anticipated loss estimates would be recognized retroactively for good book assets and immediately in full for bad book assets.

We believe the compromise proposal set forth in the recent Supplementary Document – *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – Impairment*, issued on January 31, 2011, was an attempt by the two Boards to combine the independent FASB and IASB proposals in a manner that would address both the reserve adequacy and timing of loss recognition issues with the current incurred loss model. For the reasons noted above, we believe the compromise proposal does not adequately address these issues.

We recognize that no impairment model can completely address the cyclical nature of credit risk inherent in financial instruments, and there will always be some level of volatility as we move through the ups and downs of the credit cycle. However, we believe it is possible to modify and enhance the existing incurred loss model to consider the cyclical behavior of financial instruments and lack of transparency around inherent losses in certain periods of the credit cycle in the determination of credit impairment. We believe this proposal would result in a better estimate of credit losses related to loss events inherent in the portfolio at the balance sheet date, effectively address the criticisms regarding the adequacy and timeliness of credit loss recognition and provide financial statement users with a more representative view of an entity's financial condition.

Proposal

Our proposal expands on existing incurred loss practices found within current accounting principles to more effectively estimate inherent credit losses by eliminating the probability threshold, incorporating expected events into the loss forecast and extending the loss emergence period. Under our proposal, inherent credit losses are estimated using a two-step approach. Although described in two steps, these components are interrelated and are each necessary to estimate losses inherent in the portfolio. We have described the components separately and would disclose them separately to provide clarity and transparency of management estimates:

1. A base component (the "Base Component") that represents the estimate of expected inherent losses in the portfolio that are reasonably predictable;
2. A credit risk adjustment component (the "CRA") that represents additional credit losses that are not yet reflected in current credit risk metrics used to estimate the Base Component but are estimated using macro-level factors and are expected to emerge with more transparency as the credit cycle unfolds.

Base Component

The Base Component is intended to capture expected inherent losses that are reasonably predictable based upon an assessment of historical and current credit information and expected events and conditions. The Base Component methodology replaces the current incurred loss model with an expected loss concept that incorporates expected events into the loss forecast and extends the loss emergence period to a period over which losses are reasonably predictable. Uncertainty in the forecasting process, changes in loss emergence periods, and other factors are not explicitly or systematically considered in the Base Component, and as such, the Base Component is by itself an incomplete estimate of inherent credit losses. The terms "***Expected Inherent Losses***" and "***Reasonably Predictable***" are defined as follows:

Expected Inherent Losses are defined as management's best estimate of losses inherent in the loan portfolio based on a company's credit evaluation process taking into account all relevant current and historical information as well as expected events and conditions. This is a change from the existing incurred loss definition as the "probable" threshold has been eliminated and expectations of future events can be fully considered to estimate the severity of losses associated with a loss event. Expected Inherent Losses are pro-cyclical, by nature, and reflect the portion of the total allowance for credit losses that can be reasonably predicted in the current environment based on the available evidence and trends. The elimination of the "probable" trigger in the definition of Expected Inherent Losses is necessary to allow the Base Component to capture a greater portion of the actual losses inherent in a portfolio at any given point in time and align the credit loss recognition methodology with the cyclical nature of the underlying financial instruments. We believe that a company's best estimate of losses, whether probable or not, is the correct starting point for establishing credit impairment as this information is more reflective of loss estimates used in pricing credit. We also believe that this articulation of an expected loss concept is preferable to establishing a "more-likely-than-not" threshold of incurred losses because it is better aligned with risk management, and credit loss estimation practices, which generally do not incorporate a probability weighted analysis or a pre-defined level of precision.

Reasonably Predictable is defined as the period of time that losses can be estimated with reasonable confidence. In estimating the losses that are Reasonably Predictable, several factors should be considered including, the characteristics of the financial instrument or pool of financial instruments, the historical performance of the financial instrument or pool of financial instruments, the current and expected market conditions, and consideration of a company's own credit forecasting processes. The period of time determined to be reasonably predictable will vary by asset class and may change throughout credit cycles, and will not necessarily be consistent across companies.

This methodology is not intended to result in the immediate recognition of a full life-of-instrument loss estimate in most cases because it would be unlikely that the Reasonably Predictable threshold would be satisfied unless there is a specific indication of impairment. For example, if for individual instruments or a specifically identified pools of instruments with specific indications of impairment (e.g., collection of all contractual principal or interest is not expected), all Expected Inherent Losses for that instrument or that portion of the pool of instruments would be considered Reasonably Predictable and the remaining life of loan loss would be immediately recorded similar to current accounting.

Credit Risk Adjustment Component (the "CRA")

The CRA is a separate component of the allowance for credit losses that is established to address the inherent limitations in a company's credit forecasting process and the cyclical nature of macroeconomic conditions. Past credit cycles have seen extended periods of benign activity followed by rapid parallel upward shifts in credit loss estimates. The specific economic and credit conditions that lead to the negative credit shocks often accumulate over a number of years, but often are not readily apparent in the credit metrics commonly used to estimate the Base Component. For example, a) underwriting standards and loan terms may be eased during benign credit environments; b) favorable economic conditions may mask credit weaknesses of the borrower, c) uncertainty regarding the sustainability of the current economic conditions is often high and d) loss emergence periods tend to extend during benign economic periods. Each of these factors suggests that credit losses build even during benign credit environments and these losses later become transparent as the credit cycle deteriorates. Consideration of these factors, therefore, would likely cause the CRA to be highest during these benign credit environments, thus, ensuring that inherent credit losses are appropriately recognized even during such periods. Conversely, the CRA may not be as high during times of increasing loss rates as the portfolio's loss content is reflected or more apparent in current credit quality indicators and therefore would be more fully captured by the Base Component.

Many critics have concluded that the existing model for credit impairment may not be capable of capturing the portion of losses that have been incurred, but for which, there is no currently observable evidence of credit loss. We believe the CRA concept more effectively addresses this weakness and enhances the existing incurred loss model from both a balance sheet perspective (by capturing estimates of expected inherent losses that are not readily apparent or observable), and an income statement perspective (by appropriately accelerating the recognition of credit losses into the periods in which they are inherent but not readily observable, and not concentrating loss recognition into the later stages of a credit cycle when losses are observable and can be specifically identified).

The CRA is intended to capture those losses that are inherent in the portfolio, but due to the nature of the credit cycle, will not become transparent until credit losses begin to materialize. During the course of a normal credit cycle, the counter-cyclical nature of the CRA will offset some, but not all of the volatility created by uncertainty in the timing and amount of credit losses. For example, no impairment methodology could have fully addressed the dramatic parallel shift in credit loss curves experienced from 2007 to 2009. In periods of extreme credit stress, a company may need to increase the Base Component as losses become observable, but may decide a CRA is also necessary if sufficient uncertainty remains regarding the absolute levels of expected credit losses. In this manner, the CRA addresses both criticisms, reserve adequacy and timing of credit loss recognition, leveled at the existing accounting guidance.

The methodology for establishing the CRA should consider factors including, but not limited to:

- Current credit metrics and forecast;
- Historical credit metrics (including stressed loss rates);
- Management's evaluation of the credit cycle;
- Other important credit indicators such as borrower behavior and collateral values;

- Current underwriting standards, loan covenant terms, and other loan characteristics;
- Recent trends in economic conditions;
- Portfolio performance, concentrations, and deterioration relative to historical ranges;
- Changes in loss emergence patterns over a credit cycle; and
- The level and estimate of imprecision and uncertainty in the factors above.

Many of the factors considered in the CRA would by nature be heavily dependent on management's judgment. These factors should be fully documented and supported by either market data, where possible, or internal data and analysis, and appropriately disclosed in the financial statements.

Conclusion

We believe that a credit impairment methodology that estimates credit losses inherent in the portfolio, comprising both a Base Component and a CRA, will address many of the concerns with the existing impairment model, and is superior to all other models proposed to date. We believe that the application of this methodology will:

- Generally increase the size of existing credit reserves to more accurately reflect inherent losses in the portfolio, including the risk of deteriorating economic conditions on those inherent loses;
- Reduce pro-cyclical volatility in the income statement created under the existing model as inherent losses will be appropriately recognized earlier in the credit cycle;
- Better align recognition of credit losses to those periods where credit losses are inherent in the portfolio, but are latent due to favorable economic conditions; and
- Provide more useful qualitative and quantitative disclosures to financial statement users through transparent disclosure of the different components of the allowance for credit loss calculation and enhanced information about the key methodologies, assumptions and judgments used in determining those amounts.

We believe that this methodology has a solid foundation in existing accounting principles and credit risk management practices in our industry, and is similar to concepts and practices in analogous circumstances to estimate inherent losses in other industries.