



October 20, 2011

The Honorable Leslie F. Seidman, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

The Honorable Hans Hoogervorst, Chairman
International Accounting Standards Board
30 Cannon Street
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BY EMAIL: lfseidman@fasb.org
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Chairmen of the Boards:

Thank you both again for meeting with CRUF US¹ in Boston on October 5th to discuss due process at the FASB and IASB and its implications for achieving the international convergence of accounting standards. Only the shortness of the meeting disappointed: one hour could not do justice to the topics discussed. Nevertheless, we made a good start, and I enjoyed meeting you both.

When our discussion turned to how well insurance companies had weathered the recent financial crisis compared to banks, Chairman Hoogervorst briefly made the case for expected-loss reserving as a means of improving financial disclosure for banks. The end of the meeting cut short that dialogue, which this letter seeks to continue in my individual capacity rather than on behalf of CRUF US or my firm, Sandler O'Neill + Partners, L.P.

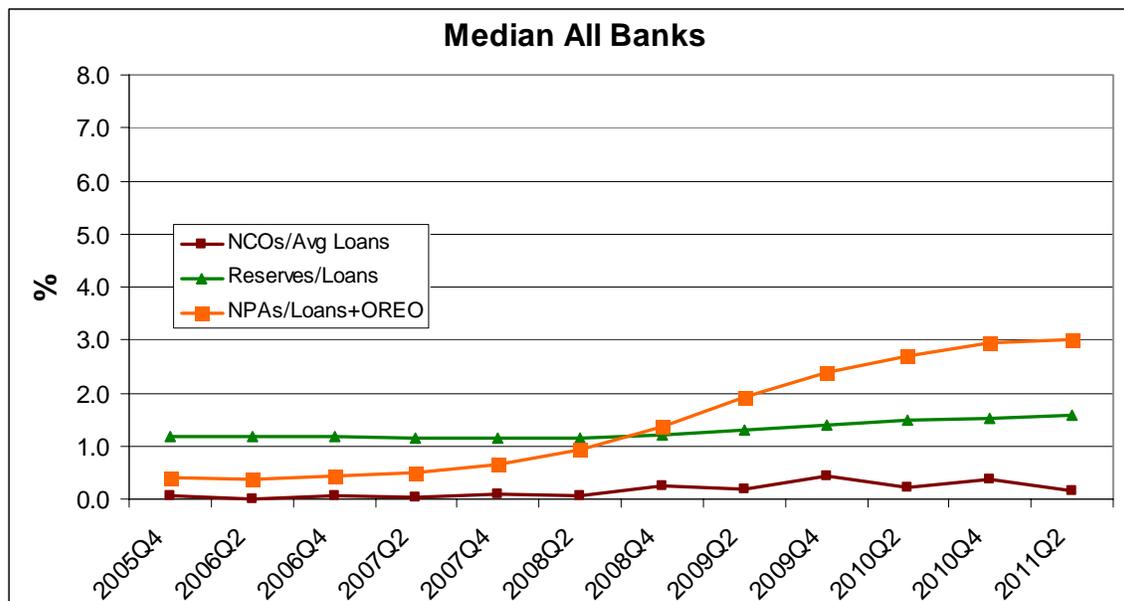
In my firm's attached March 28, 2011 comment letter on the boards' joint project on impairment, I stated my firm's belief that the fundamental task before the boards is the principled determination of the extent to which unconfirmed credit losses should be covered by reserves rather than capital. Within that framework, my firm views the FASB's separate approach as an improvement on its previous proposal to eliminate the probability threshold from the incurred-loss model, facilitating the worthwhile goal of earlier recognition of reasonably estimable credit losses.

¹ CRUF US is part of the Corporate Reporting Users' Forum (CRUF), an international discussion forum consisting of investors and analysts dedicated to engaging the FASB and IASB as they set accounting standards. For additional information on CRUF, see <http://www.cruf.com/index.html>. Neither CRUF nor CRUF US has any affiliation with Sandler O'Neill + Partners, L.P., which is an investment banking firm and registered broker-dealer. For additional information on Sandler O'Neill, see <http://www.sandleroneill.com/>.

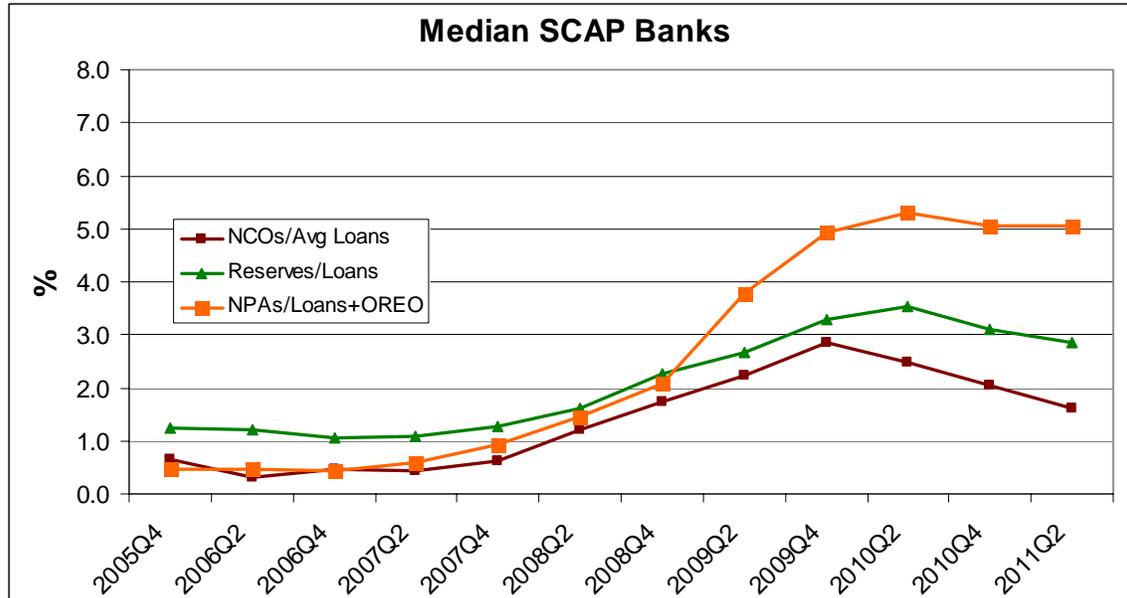


Our impairment analysis of U.S. banks in Appendix B to that letter demonstrates that the crux of the problem in the recent financial crisis was not an incurred- versus expected-loss approach to reserves but, rather, that the financial system was awash in too many assets for which no reserve methodology would have been adequate. For the best-performing quartile of U.S. banks, reserves remained adequate to cover nonperforming assets. For the worst-performing quartile of such banks, NPAs quickly and dramatically overwhelmed reserves.

For the benefit of the boards in their ongoing impairment deliberations, analyst Jason Mendelson and I revisited our earlier analysis in the following two graphs, again using SNL Financial data. Applying the same methodology described in Appendix B to our firm’s comment letter, we updated our analysis and rolled it forward for the first half of 2011. The “Median All Banks” graph immediately below includes all unconsolidated U.S. banks and thrifts reporting at June 30, 2011. The “Median SCAP Banks” graph on the next page is a subset of twelve consolidated U.S. banking firms subject to the U.S. Supervisory Capital Assessment Program (SCAP) chosen to create a proxy for the universal banking model more commonly found in large, non-U.S. banking firms.²



² Our SCAP bank cohort includes Bank of America Corp., JPMorgan Chase & Co., Citigroup Inc., Wells Fargo & Co., U.S. Bancorp, PNC Financial Services Group, Inc., State Street Corp., SunTrust Banks, Inc., BB&T Corp., Regions Financial Corp., Fifth Third Bancorp, and KeyCorp.



Whatever conclusions available data might permit regarding large European banks, there are a number of obvious conclusions to be drawn concerning large U.S. banks, both in themselves and compared to the cohort of all U.S. banks.

- The financial crisis was sudden and extreme in its onset, with NPAs overwhelming reserves in both cohorts in early 2009.
- The amplitude of credit deterioration (measured by both NPAs and NCOs) was greater for SCAP banks, and NPAs peaked earlier for SCAP banks.
- As the crisis deepened, reserves rose with but lagged NPAs in both cohorts, covering NPAs less fully for SCAP banks.
- Throughout the crisis, reserving reflected loss experience in both cohorts, rising with increasing losses and moderating or trending down with improving loss experience.

What emerges from this analysis is a portrait of U.S. banks of both cohorts responding in a rational, measured, and responsible manner to an extraordinary credit crisis. As NPAs overwhelmed reserves and NCOs escalated, banks built reserves until loss experience signaled that the worst had passed. Any bank that had been fully reserved for the crisis before its onset would have appeared so delusional that neither its shareholders nor supervisors would have tolerated the disclosure of such reserve levels.

Of course, what is missing from our analysis is the capital backstop to reserves, which we chose to omit because of the extraordinary variable of the U.S. Treasury's equity investments in the banking system. The boards, however, should be mindful that their



task is, as we indicated earlier, the principled determination of the extent to which unconfirmed credit losses should be covered by reserves rather than capital under circumstances less extraordinary than the recent financial crisis and under newly enhanced capital requirements.

The foregoing analysis is a documented way of saying that the incurred-loss model of reserving is not as broken as the boards' exposure documents imply, a sentiment shared by significant majorities of the investors and bankers we surveyed (see attached letter).

The simple expedient of revising current impairment guidance to require immediate recognition of credit losses expected in the foreseeable future would sufficiently address the putative "too little, too late" deficiency of current guidance and provide a more accurate reflection of management's estimate of expected credit losses. Such an approach would avoid unnecessary complexities, including those of the new three-bucket model, as well as penalties for banks arising from Basel III's capital treatment of loss reserves and related deferred tax assets.

Very truly yours,

A handwritten signature in black ink that reads "Joseph Longino".

Joseph Longino
Principal

Attachment: SOP Comment Letter to FASB (March 28, 2011)



March 28, 2011

Financial Accounting Standards Board
401 Merritt 7
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BY EMAIL: director@fasb.org

RE: File Ref. No. 2011-150
Financial Instruments: Impairment

Members of the Board:

On behalf of Sandler O'Neill + Partners, L.P., I am commenting on the Board's Supplementary Document, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment* (January 31, 2011).

The Financial Accounting Standards Board ("Board" or "FASB") published the Supplementary Document pursuant to a joint project with the International Accounting Standards Board ("IASB") to assist the Board in developing an exposure draft proposing revisions to accounting for impaired financial instruments. Written comments on the Supplementary Document are due no later than April 1, 2011.

Sandler O'Neill is a full-service investment-banking firm focused on the financial services sector.¹ Our clients include a wide variety of financial firms, among them almost 1,000 banks and thrifts (collectively, "banks") and their holding companies. We address the Board not as accountants but as a firm of financial professionals who work closely with many financial firms.

Overview

In its Supplementary Document the Board has exposed for comment two approaches to recognizing credit impairments on assets that are loans and debt securities not fair valued through earnings.²

¹ For further information on Sandler O'Neill + Partners, L.P., see <http://www.sandleroneill.com/>; author contact information: jlorgino@sandleroneill.com or 212-466-7936.

² In addition to the joint FASB/IASB approach and the separate FASB approach summarized in this overview, the Supplementary Document also presents a separate IASB approach. The joint approach consists of the FASB and IASB approaches, the latter of which we do not discuss because our concerns about the joint approach apply equally to the IASB approach. See



The FASB/IASB joint approach would recognize in current earnings a time-proportional amount of expected lifetime credit losses on “good book” assets, subject to a floor amount of losses expected in the foreseeable future, and for “bad book” assets would recognize in current earnings all expected lifetime losses.³ The FASB’s alternative, separate approach would recognize in current earnings all credit losses on good-book and bad-book assets expected to occur in the foreseeable future. By contrast, the existing impairment model recognizes in current earnings only credit losses that are probable to have been incurred.

We view the FASB’s separate approach as an improvement on its previous proposal to eliminate the probability threshold from the incurred-loss model, facilitating the earlier recognition of reasonably estimable credit losses. The fundamental task before the Board is the principled determination of to what extent unconfirmed credit losses should be covered by reserves rather than capital.

As we explain more fully herein, we urge the Board not to propose or adopt the joint approach to revising impairment guidance because

- It would not have helped in the recent financial crisis, the crux of which was a failure of underwriting rather than reserving,
- It is unnecessarily complex and theoretical rather than practical,
- It would generate highly speculative data that would be neither verifiable nor comparable, hence not useful,
- It would penalize banks subject to the Basel III capital conservation and countercyclical buffers and limitations on deferred tax assets in capital, and
- It lacks the support of both bankers and investors.

Instead, the Board should issue an exposure draft proposing its separate approach to revising current impairment guidance, fully comparing and contrasting its expected-loss approach with the existing incurred-loss model, and should remain open to the possibility that the latter may not be as deficient as its more partisan critics claim.

The Proposal in Context

We believe the best way to approach the boards’ Supplementary Document is to assess it in context, which includes the recent financial crisis, the Basel III capital and liquidity framework, and existing practice in recognizing impairments.

Appendix A to this letter for a more detailed summary of the three approaches, which for convenience we sometimes refer to as the “Proposal.”

³ The bad book would consist of assets whose collectability has become so uncertain that the holder’s management objective has changed from receiving contractual payments to recovering potential losses.



The Financial Crisis

The incurred-loss impairment models in use during the financial crisis were criticized for (i) not recognizing losses soon enough, (ii) not incorporating information forward-looking enough to encompass the lifetime of assets and complete economic cycles, and (iii) not providing a uniform approach to the impairment of similar assets.⁴

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

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

There is a legal maxim that “hard cases make bad law.” It posits that difficult or unusual facts provide a poor basis for a law or rule of general application that must cover a wider range of less extreme circumstances. Such is the case here, particularly with respect to the FASB/IASB joint approach, which would have significant unintended adverse consequences without addressing the perceived problem, as we discuss below.

Targeted improvements to existing impairment methodology are far preferable to its overreaching replacement, and to the extent the Board’s separate approach were to accomplish this, bankers and investors could support it.

Basel III Capital Framework

Capital-Conservation and Countercyclical Buffers

Insofar as the “too little, too late” criticism of incurred-loss impairment methodology has any validity, the Basel III capital-conservation and countercyclical buffers have already substantially addressed it. The conservation buffer

⁴ See Basel Committee on Banking Supervision, *Guiding principles for the replacement of IAS 39* (August 27, 2009), p. 3.



is designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred. The requirement is based on simple capital conservation rules designed to avoid breaches of minimum capital requirements.⁵

When fully implemented, the conservation buffer will require common equity Tier 1 capital in an amount equal to 2.5% of risk-weighted assets in addition to a minimum amount of such capital of 4.5% of risk-weighted assets, for a total 7.0% requirement.

The Basel III capital framework also provides for a discretionary countercyclical buffer that would be implemented as an extension of the capital-conservation buffer and could raise the Tier 1 capital requirement to as much as 9.5% of risk-weighted assets.⁶ The countercyclical buffer attempts to protect against losses that could arise from the buildup of systemic credit risk associated with “excess” aggregate credit growth. The imposition of a countercyclical buffer or increase in it would be pre-announced to permit time for banks to adjust, whereas decreases would take effect immediately.

Banks having less than the full amount of the conservation or countercyclical buffer will be subject to stricter constraints on capital distributions that completely prohibit such distributions as either buffer is exhausted.⁷

In short, the Basel III capital framework has substantially addressed through capital requirements the perceived “too little, too late” deficiency of incurred-loss impairment practice, and in a manner that avoids the punitive effects on capital of excessive deferred tax assets.

Deferred Tax Assets

When fully implemented, the Basel III framework will subject deferred tax assets (“DTAs”) related to the allowance for credit losses to two separate caps on capital inclusion and onerous risk weighting. DTAs will be included in common equity Tier 1 capital only in an amount up to 10% of common equity. They will also be subject to a limitation of 15% of common equity when aggregated with mortgage servicing rights and investments in the capital instruments of other unconsolidated banking, financial, and

⁵ Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (“Global Framework”) (December 2010), p. 54.

⁶ *Global Framework*, pp. 57-60.

⁷ We note that in the United States, bank supervisors routinely impose needed supplemental capital buffers if bank management has failed to build them, as well as companion constraints on capital distributions.



insurance entities. Finally, any of these three assets, including DTAs, that are included in common equity Tier 1 capital will be risk weighted at 250%.⁸

In short, credit impairments are a triple whammy for banks under the Basel III capital framework: earnings and capital are reduced when they are recognized, related deferred tax assets are subject to strict caps on capital inclusion, and DTAs that survive running this gauntlet are risk weighted at 250%. The more, and the earlier, credit losses are recognized, the more punitive this Basel III triple whammy becomes.⁹

While disclosure requirements have not been fully addressed, we believe it inconceivable that the full amount of estimated lifetime losses in the good book would not be subject to disclosure. From disclosure, it is but a short additional step to requiring this quasi-suspense account to be on the balance sheet rather than off, where its tax-effected amount could then materially enlarge deductions from capital under the Basel III capital framework.¹⁰

Current Impairment Practice

The Basel III capital-conservation and countercyclical buffers take their cue from existing incurred-loss impairment practice, in which capital, rather than the allowance, is the cushion against possible future losses. On the spectrum of incurred, expected, and possible credit losses, the more distant the time horizon over which losses are estimated, the less “expected” and the more merely “possible” they become.

This gradation of certitude in credit loss estimation argues strongly for the FASB’s separate approach to impairment, which would recognize in current earnings all credit losses on good-book and bad-book assets expected to occur in the foreseeable future. Beyond a horizon of 24 months at most, and more commonly between 12 and 18 months, credit losses become so speculative that best practice and common sense suggest committing them to coverage by capital, which is precisely what the Basel III capital-conservation and countercyclical buffers do.

We agree with FASB board members who believe that requiring immediate recognition of credit losses expected in the foreseeable future sufficiently addresses the putative

⁸ *Global Framework*, pp. 22 & 26. DTAs currently includable in U.S. banks’ Tier 1 capital may not exceed the lesser of 10% of Tier 1 capital or DTAs expected to be realized within one year.

⁹ Our preliminary understanding is that the required deduction from common equity Tier 1 capital of any amount by which reserves fall short of forward-looking provisioning will apply only to internationally active banks using the Internal Ratings-Based (“IRB”) Approach under Basel III. See *Global Framework*, p. 22.

¹⁰ Subject to transitional arrangements, common equity Tier 1 capital includes “accumulated other comprehensive income and other disclosed reserves,” with no adjustment applied to remove unrealized gains or losses recognized on the balance sheet. *Global Framework*, p. 13 & fn. 10.



“too little, too late” deficiency of current impairment guidance and provides “a more accurate reflection of management’s estimate of credit losses expected to occur in the allowance balance” without the complexity of the time-proportional component preferred by the IASB.¹¹

We understand the theoretical appeal of the time-proportional recognition of expected lifetime credit losses, but believe the estimation of such losses beyond the foreseeable future and their time-proportional recognition to be too speculative and complex to provide accuracy, transparency, and comparability. In addition, the adjustment of assumptions and re-measurement of allowance amounts required at each reporting date would muddle financial reporting even further. The simpler expedient of immediately recognizing credit losses expected in the foreseeable future minimizes the need for discounting and allocating them, thereby better promoting accuracy, transparency, and comparability.

Finally, because it is closer to current impairment practice, the FASB standalone approach lends itself better to addressing the many unresolved issues on which the boards have requested comment, including providing for credit losses on off-balance-sheet loan commitments, standby letters of credit, and guarantees.¹²

In short, the FASB standalone approach is demonstrably more operational in every way than either the joint or IASB approach, in no small part because of the widespread use and acceptance of its basic approach, differing from current practice chiefly in the substitution of expected for incurred losses.

What Bankers and Investors Want

The week of March 14th the Investment Strategy Group of Sandler O’Neill conducted a survey of bankers and institutional investors in banks who receive research from the firm’s Equity Research Department. That survey is reproduced in Appendix C to this letter.¹³ Of 73 total responses, 46 were from bankers and 27 were from institutional investors.

Fully 70% of institutional investors opposed both the joint approach and the FASB alternative approach, while 81% of investors supported current practice. Minorities of

¹¹ Supplementary Document, pp. 46-47.

¹² Any allowance for credit losses on these items is currently reported on the balance sheet as an “Other Liability,” not as part of the ALLL. For existing practice generally, see OCC, FRB, FDIC, NCUA, & OTS, *Interagency Policy Statement on the Allowance for Loan and Lease Losses and Questions and Answers on Accounting for Loan and Lease Losses* (December 13, 2006).

¹³ We counted all answers, including those that were inconsistent with the decision tree implicit in the survey’s three questions.



30% of investors supported both the joint approach and FASB approach, with only 19% opposing current practice.

The results for bankers were similar but more pronounced: majorities of 93% and 91% opposed the joint approach and FASB alternative approach, while 96% supported current impairment practice. Minorities of 7% and 9% of bankers supported the joint approach and FASB approach, with only 4% opposing current practice.

Our survey is admittedly limited, but we have no reason to believe that a more scientific sampling would yield substantially different results. Some 73 bankers and investors were sufficiently motivated to work through interconnected questions that were of necessity syntactically and substantively complex, and they have spoken clearly.

What is particularly striking is the lack of support for either the joint or FASB alternative to the incurred-loss model among institutional investors, the primary users whom the Board most seeks to serve in developing accounting standards.

What the Board Should Do

The standard for action the Board has set for itself is found in Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting* (September 2010), which provides:

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors ["primary users" (OB5)] in making decisions about providing resources to the entity (OB2).

If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, and understandable (QC4).

Based on this standard for action, we believe the Board should issue an exposure draft proposing the revision of impairment guidance to require the recognition in current earnings of good-book and bad-book credit losses estimated over the foreseeable future, without specifying what that time horizon should be. Foreseeability is variable, and its determination should be left to the judgment of management.

Given the strong preference of bankers and investors for existing impairment guidance, the Board should fully compare and contrast its expected-loss approach with the incurred-loss model and remain open to the possibility that existing guidance may not be as deficient as its more partisan critics claim.



We urge this course of action upon the Board because its approach is more operational than the joint or IASB approach in estimating and recognizing verifiable, comparable, and understandable credit loss estimates helpful to primary users, while also addressing the putative “too little, too late” deficiency of existing credit impairment guidance.

We hope the IASB can be persuaded to join the Board in a fully converged approach supported by preparers and users of financial statements, but if not we believe Concepts Statement No. 8 obliges the Board to go its own way without the IASB. There is but one reference to convergence in Concepts Statement No. 8, in which it clearly is what it should be: a secondary, aspirational principle of action to be given effect *only* if consistent with the primary, mandatory desiderata of that statement.

Very truly yours,

A handwritten signature in black ink that reads "Joseph Longino".

Joseph Longino
Principal



APPENDIX A

Summary of the Proposal

The scope of the proposal is limited to recognizing impairment of loans and debt instruments (i) that are not measured at fair value through earnings and (ii) that are managed in “open” portfolios characterized by the addition of such assets through origination or purchase and their removal through repayment, sales, write-offs, or transfers to other portfolios.

The proposal does not address loans and debt securities that are credit impaired at acquisition, nor does it address troubled debt restructurings. The FASB has not determined how loan commitments should be addressed, and the IASB has requested comment on how the joint approach should be applied to loan commitments and financial guarantee contracts.

Joint Approach

Open portfolios would be divided into two books of assets based on the holder’s individual internal credit risk management policies: the “good book” and the “bad book.” The latter would consist of assets whose collectability has become so uncertain that the holder’s management objective has changed from receiving contractual payments to recovering potential losses.

Expected credit losses on assets in the good book would be estimated on a pool basis over their lifetime and recognized in current earnings as a time-proportional amount, subject to a floor amount of losses expected in a foreseeable future of at least 12 months. Expected lifetime losses in the bad book would be recognized in earnings immediately. The total allowance would be the sum of allowances for the good and bad books, which would be re-measured at each reporting date.

All internally and externally available information, including reasonable and supportable forecasts of future events and economic conditions, would inform the estimation of credit losses over the remaining lifetime and foreseeable future.

Either a straight-line approach or an annuity approach could be used to allocate expected losses over the remaining life of the good-book portfolio. Discounted or undiscounted expected losses could be used for the straight-line approach. For the annuity approach, a discounted cash flow calculation of expected losses would determine a present value amount, which would be converted into an annuity to be allocated over the life of the portfolio and recognized periodically in profit or loss. The target allowance under the annuity approach would consist of the accumulated annuity, including the interest component.



The discount rate used could be any reasonable rate from a risk-free rate to an effective interest rate, excluding expected credit losses.

Separate Approaches

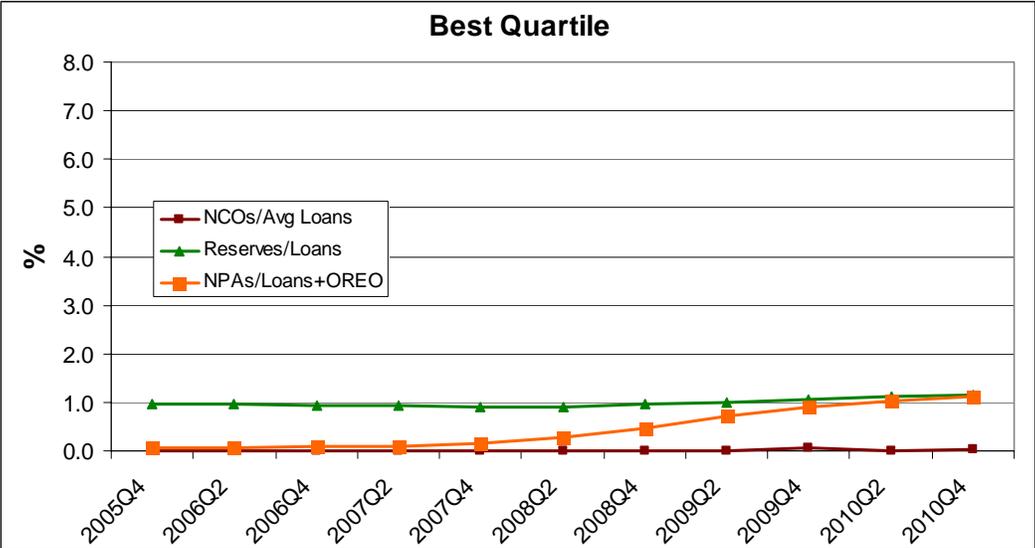
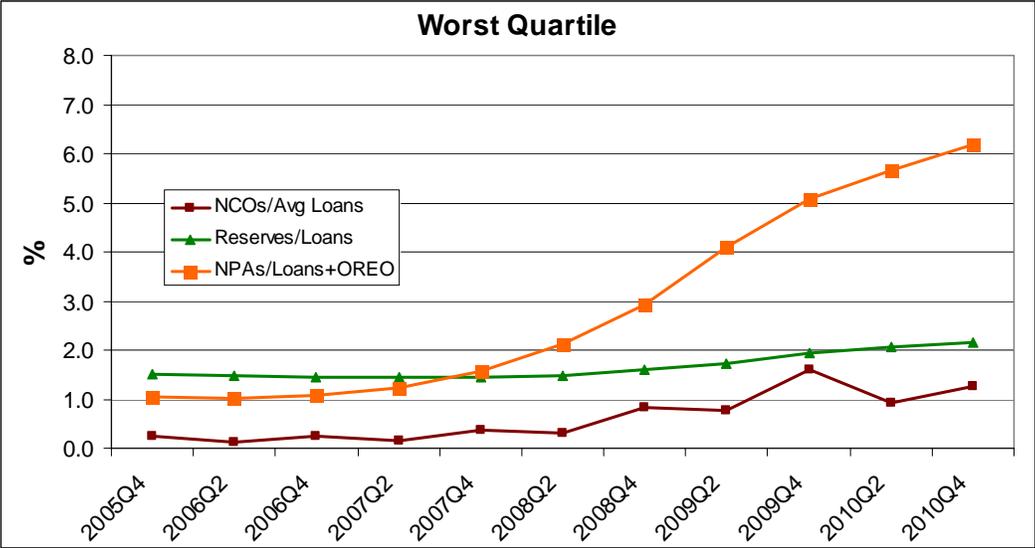
While preferring convergence, the boards are also requesting comment on their separate models. In essence, the IASB approach emphasizes earnings over time, while the FASB approach emphasizes current financial position.

The IASB model is the joint approach without the floor, consisting of the time-proportional amount for the good book and full lifetime expected losses for the bad book. IASB members supporting this approach believe that such a model better reflects the economics or pricing of lending transactions by aligning interest income with credit loss expense over the expected life of a portfolio.

The FASB model is the joint approach without time-proportional lifetime losses. It would immediately recognize all credit losses expected to occur in the foreseeable future, likely making the distinction between the good and bad books unnecessary because credit losses in the latter would presumptively occur in the foreseeable future. FASB members supporting this approach believe it to be more operational in generating simpler, more reliable loss estimates that would provide an allowance adequately anticipating actual losses before they occur.



**APPENDIX B
 Financial Crisis Bank Impairment Metrics**



Source: SNL Financial

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



APPENDIX C
FASB/IASB Impairment Proposals Survey
Conducted Week of March 14, 2011

Please respond now to this three-question survey to help Sandler O'Neill prepare a comment letter to the FASB on an accounting proposal important to banks and thrifts and investors in them. Only aggregate data will be used: no individual responses will be disclosed. Thank you.

* * * * *

For assets that are loans and debt securities not fair valued through earnings:

1. Do you support the FASB/IASB joint proposal to recognize in current earnings a time-proportional amount of expected lifetime credit losses on "good book" assets, subject to a floor amount of losses expected in the foreseeable future, and for "bad book" assets to recognize in current earnings all expected lifetime losses?

Yes _____ No _____

2. If not, do you support the alternative FASB proposal to recognize in current earnings all credit losses on "good book" and "bad book" assets expected to occur in the foreseeable future?

Yes _____ No _____

3. If not, do you support keeping the existing impairment model that recognizes in current earnings only credit losses on assets that are probable to have been incurred?

Yes _____ No _____



cc: International Accounting Standards Board
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