November 23, 2011

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

Hans Hoogervorst, Chairman
International Accounting Standards Board
First Floor 30 Cannon Street
London, EC4M 6XH
United Kingdom

RE: Principles Related to the “Three Bucket” Impairment Model

Dear Chairman Seidman and Chairman Hoogervorst:

The American Bankers 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 have observed the efforts of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to pursue changes to the impairment models, we applaud both boards for conducting a thorough and in-depth process thus far. Impairment is a complex issue that is a critical component in understanding financial statements for the banking industry worldwide. Although the process has been long and tedious for all participants, including the boards and industry, it is worthwhile. Significant progress has been made, and we urge you to continue the deliberations in order to get to the right global solution without being rushed.

We appreciate the outreach conducted by the boards and your staffs to the ABA and many U.S. banking institutions in order to understand credit process and the concerns of bankers. We believe this outreach has allowed your boards to better understand the challenges of managing credit risk and estimating the financial impact of changes in credit risk. With this in mind, ABA supports the general direction of the “Three Bucket” impairment model (the Model), as the Model attempts to both align credit risk recognition with credit management practices, and credit risk measurement with credit risk levels. As your boards approach completion of the overall structure of the Model to be proposed, ABA recommends that the following issues be addressed prior to issuing an exposure draft:

1. A time-based ceiling is inappropriate to estimate losses on bucket 1 loans.

Bankers in the U.S. believe that the measurement objective of the Model should be to record the inherent losses in the portfolio that can be reasonably estimated as of the reporting date. In practical terms: “Given everything you know, how much do you think you will lose on the loans recorded on your books?” With that in mind, the measurement objective of bucket 1 loans – loans that are unimpaired and have no foreseen emerging credit risks – should be no different from the objective for bucket 2 loans, which consist of those unimpaired loans for which emerging credit risks are foreseen.
There has been much discussion on the measurement principle for bucket 1 loans, with a twelve-month ceiling, or horizon, being one of the options. ABA believes that setting an arbitrary twelve-month ceiling for losses on bucket 1 loans will unnecessarily reduce loan loss allowances from current levels, while simultaneously adding unnecessary volatility to the overall allowance. This would not represent an improvement over current impairment standards. Currently, bankers in the U.S. are estimating losses with reasonable reliability for many loan portfolios with emergence periods that exceed twelve months.\(^1\) In some portfolios, these loss estimates (which we believe to approximate the impairment being sought in the Model) can represent emergence periods of two to three years. Arbitrarily setting caps on these loss estimates will not reflect the expectations of management, will unnecessarily exacerbate volatility in the overall allowance (from the “cliff effect” that comes from changing the measurement objective between bucket 1 and bucket 2 loss estimates), and will reduce comparability between organizations (due, among other things, to different charge-off practices among the various countries that are your constituents).

ABA understands that specific twelve-month expected loss estimates are made for certain regulatory purposes. Financial forecasting is also often performed on a twelve-month basis, with longer horizons naturally resulting in less precision. We believe a qualitative principle should guide how impairment is measured in bucket 1, rather than a specified time period. If a time-based bright-line is required, ABA recommends that, instead of a twelve-month ceiling for bucket 1 allowances, there be a twelve-month floor (unless the life of the portfolio is less than twelve months). A twelve-month floor will help address the cliff effect, will allow for differences in lending products, and will most accurately reflect the capabilities bankers have to reliably estimate losses on loans that are currently unimpaired.

2. The conceptual basis of measurement for each bucket should be on impairment – not on any concept related to income recognition.

Consistent with the discussion on the overall measurement objective noted above, there is no need to establish a separate and distinct conceptual basis for bucket 1 impairment measurement. ABA understands that there are some who believe that a twelve-month loss represents a yield adjustment – the loan losses match the credit-risk portion of interest income that is earned. However, this concept does not satisfactorily address specific kinds of loans (in addition to many commercial loans, many adjustable rate mortgages and balloon loans are obvious examples) where the default and resulting charge-off may be delayed by two to three years because of the unique natures of the products and borrowers. ABA believes that the conceptual basis for any part of an impairment model should be focused solely on the adequacy of the allowance. Criticisms of the current “incurred” model center on the adequacy of the allowance, so to insert concerns related to an appropriate net yield only confuses the matter, whereas, a consistent focus on the recognition of inherent losses among the buckets will be easier to understand and explain to users of financial statements.

\(^1\) This estimates the amount of expected losses that will ultimately result in charge-offs, or direct reductions, to the loan balance.
3. The conceptual meaning of bucket 2 must be clear.

The difference in loss measurement between twelve-month (bucket 1) verses a life-of-loan (bucket 2) has brought much confusion, as well as contention, to discussions among bankers. These discussions can be much more productive if the conceptual meanings – both in classification and in measurement – of bucket 2 loans are clarified. We understand that the staff is considering deleting reference to “life-of-loan” and “life-of-portfolio” losses within bucket 2, and we strongly support this. These references introduce unnecessary complexities (such as determining a portfolio lifespan) that do not address the practical question: How much does a banker think will be collected? We believe this is information that is most useful to bankers as well as to users of bank financial statements.

As noted above, we believe our recommendation for the conceptual meaning for bucket 2 classification – unimpaired loans for which emerging credit risks are foreseen – clearly differentiates these assets from bucket 1 assets and (since the measurement objective is the same) makes clear that these assets are subject to greater analysis and potentially greater allowances than similar types of loans that are in bucket 1 due to asset quality.

4. “Too little too late” should be explicitly addressed.

Four years after the beginning of the financial crisis, the “too little too late” criticism of the current incurred loss model still routinely comes up. While the discontinuation of “probable loss triggers” will enable bankers to record more allowances earlier, ABA believes that auditor and regulator concerns about “earnings management” criticisms may diminish management’s ability to recognize inherent losses earlier in the credit cycle under the proposed model unless the model specifically addresses “too little too late” concerns.

With this in mind, we recommend that the boards consider how a “credit risk adjustment” (CRA) component of the allowance – one that represents credit losses that are not yet reflected in current credit risk metrics – can be integrated into the Model. This component, which was detailed in the “U.S. Banking Industry Impairment Proposal” submitted with our April 1 comment letter related to the Exposure Draft on the Time Proportionate Allocation model, is estimated based on nontraditional and forward-looking metrics, such as changes in a bank’s underwriting standards or macroeconomic trends (such as home affordability indices). These nontraditional analyses may indicate that losses exist in the portfolio, though are not quantifiable through current reliable methods. Without a concept similar to the CRA, ABA is not confident the “too little too late” issue will be adequately addressed.

5. Discussion must be given to whether the Model is appropriate for debt securities.

While the boards have discussed in depth the overall Model as it relates to loans, there has been little analysis of how suitable the Model is for debt securities (with the exception of how banks
would record losses in context of the current Sovereign Debt Crisis). Some bankers in the U.S. are satisfied with the current Other Than Temporary Impairment standards and are not aware of any criticisms from users. Therefore, they do not see any reason to change methods for debt security impairment if the new model does not represent a clear improvement over today’s methods. Therefore, we recommend dedicated and thorough analysis be performed prior to issuing the exposure draft. Our primary focus has been on loans rather than debt securities, and we are concerned that this will be the case among your constituents during the comment phase if there has been little discussion on the applicability of the Model to debt securities.

6. There should be one Model for both originated and purchased loans.

Currently, a significant amount of time is being consumed to account for purchased loans with no measurable benefit. For example, bankers provide adjusted recorded balances of purchased loans to assist banking analysts in assessing the overall adequacy of the loan loss allowance. Current requirements from AICPA Statement of Position No. 03-3 and FASB Statement No. 141(R), yield confusing information to financial statement users. It is difficult for them to understand both credit quality and subsequent income recognition. Further, SOP 03-3’s nonsymmetrical treatment of changes in cash flow assumptions (improvements are amortized, while deterioration is immediately recognized) frustrates users and preparers alike in understanding the results.

With this mind, we recommend the boards accept one Model for all loans. This would entail a presentation for purchased loans, whereby a loan loss allowance is recorded upon acquisition, with the interest rate and liquidity adjustments to par value amortized into income consistent with current purchase price premium/discount amortization requirements. Consolidating the process for originated and purchased loans will result in an operational ease for the banks and will be much more responsive to consistent calls from the user community to integrate purchased loans into traditional credit statistics.

7. Methods of loss measurement should not change.

While not specifically part of the discussions related to the structure of the Model, certain decisions the boards have made regarding loss measurement will add unnecessary complexity to the process and perhaps mislead financial statement users as to the inherent uncertainty of loss estimates. As a result, we recommend that the boards reconsider, prior to the issuance of an exposure draft, the following issues:

- Impairment should not include interest – The nonaccrual process in the U.S. is relatively straightforward and is well understood. The decision to include interest in the impairment process adds unnecessary complexity to the process and does not appear to significantly improve the information provided.

- “Expected Value” should not be used as a measurement – The “Expected Value” concept, which equates to a probability-weighted impairment measure, adds significant complexity to the impairment measurement process and will not improve the information provided.
The probability-weighted concept implies a precision and reliability that will not likely exist. The current U.S. practice of using a “best estimate” is the most accurate way to determine an amount that is, in the end, highly judgmental. To make users of financial statements believe otherwise is misleading.

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 thank you for 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. 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