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Comment Letter No. 17A

American Bankers Association
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Technical Director
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Via email: director@fasb.org

File Reference: No. 2013-220 *Recognition and Measurement of Financial Assets and Financial Liabilities*

Dear Chairman Seidman:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Exposure Draft: *Recognition and Measurement of Financial Assets and Financial Liabilities* (ED). ABA represents banks of all sizes and charters and is the voice for our nation's $14 trillion banking industry and its two million employees.

One of the goals of the ED is to "simplify" the classification of financial assets and liabilities. We support such efforts as well as attempts to streamline accounting processes and the decision-usefulness of the resulting financial statements. The ED represents a major improvement over the exposure draft issued in 2010, which proposed expanding "fair value accounting"[1] to nearly all financial instruments. The Board appropriately listened to its constituents and determined that fair value should not be the primary measurement attribute for loans. However, we believe the ED does not represent an improvement to the current classification and measurement model, and we continue to be concerned about the impact of the proposed changes on the banking industry's business. Specifically, we believe the current proposals in the ED would unnecessarily increase the number of financial instruments carried at fair value, making the cost/benefit test difficult to pass. Thus, we believe the best course of action is to retain current GAAP related to the overall classification model. Changes that need to be made to the existing model are discussed in this letter.

Specific concerns about the ED

Although the ED represents a significant improvement over the 2010 proposal, it does not represent an improvement over current accounting. Additionally, the ED effectively causes fair

[1] "Fair value" is the technical term used in the ED and in other accounting standards, though we believe "mark to market" is more descriptive and we have used "market value" and "mark to market" in place of "fair value" in other comment letters.

value to be the default measurement, with amortized cost being a privilege. We believe this contradicts what the FASB learned from constituents during the 2010 exposure draft period. We believe current GAAP is working, understandable, and does not need to be changed. Although we support the notion of convergence, in this case the goal of convergence would result in an inferior accounting standard, which we do not support. If the FASB believes there are problems with the current GAAP framework, then those specific problems should be discussed, rather than disposing of them.

As noted in our comment letter on the 2010 proposal, an emphasis on fair value distorts the cash flows expected by the bank, is costly to maintain, and unfairly and unnecessarily disadvantages those institutions that extend the least liquid loan products. In brief, the primary concerns we have with the ED are:

- SPPI (solely principal and interest) test – The SPPI test is introduced in the ED, and presumably the goal is to require mark to market accounting for instruments with higher variability in cash flows, while maintaining amortized cost for the least risky. Combined with the inability to bifurcate or to reclassify (as discussed below), requiring the cash flows from the instruments consist solely of principal and interest in order to avoid fair value accounting potentially elevates fair value to almost the same level as the 2010 proposal, which was strongly opposed by constituents. The SPPI test will cause more assets to unnecessarily be accounted for at fair value, with changes recorded through net income (FVNI). Along with the fact that FVNI is the "residual" classification, this presumes that the appropriate measurement for debt instruments is FVNI. Additionally, due to the stringent definitions of "principal," "interest," "more than insignificant leverage," "more than insignificantly different from the benchmark cash flows," and "reasonable additional compensation," many common loan products and portions of securitized assets will, at a minimum, necessitate significant efforts to analyze compliance with SPPI.[2] This will have an impact on both loans and investments in securitized assets.[3]

- Inability to bifurcate – Any instrument with a non-SPPI-related component (whether it is a lending term that does not qualify under the SPPI test or is an embedded derivative) must be accounted for within FVNI. By disallowing bifurcation of hybrid financial assets, FVNI accounting is required for the whole instrument. Because loan markets typically have less liquidity (and, as a result, generally more volatile fair values), unnecessary volatility will flow through net income. Since this volatility will never be realized if the intent is to hold for collection of cash flows, this treatment will distort earnings.

[2] ABA believes that SPPI represents a large expansion on the current "clearly and closely related" criterion that requires derivative (fair value) accounting. Many differences in loan terms, such as interest rate reset bases, "punitive" credit spreads, and "leverage" components (as explained in the ED) will require significant analysis over what is commonly performed now.

[3] During our discussions about the SPPI test, we attempted to develop new terminology that would be less limiting than "solely" principal and interest." For example, we discussed the idea that the test might be "primary purpose" of the instrument is principal and interest. However, this does not overcome our concerns about the default measurement being fair value.

- Inability to reclassify – Reclassification of assets is not allowed, which may significantly increase the number of loans that will be accounted for in fair value through OCI (FVOCI). This contradicts what was learned from constituents in the 2010 ED. Without having the ability to reclassify loans and securities, many loans (that would otherwise be at amortized cost) will be recorded at FVOCI. Loans that have historically been reclassified without controversy – those put up for sale due to management of credit concentrations or those that are related to a mortgage banking business (though not ultimately sold) -- are, thus, at risk of FVOCI classification. Similar to the inability to bifurcate, unnecessary fair value adjustments will be reported, this time within OCI.

- "Exit price" on face of balance sheet – For financial assets of public companies accounted for at amortized cost, parenthetical disclosure of fair value on the face of the balance sheet, based on "exit price," is required. Eliminating the practical expedient of using "entrance price" and replacing it with a requirement to disclose "exit price," along with the new footnote disclosures now required, will add significant costs, with little benefit, as financial statement users will continue to see significant differences among banks in their fair value calculations. We believe that including it on the face of the balance sheet implies a level of precision and comparability that does not exist for most banks' loans as well as other financial instruments. Further, those public entities serving the least liquid markets will find themselves explaining why their fair values are relatively lower than those serving more liquid markets.

- Core deposit disclosures – Required disclosure for public companies of core deposit information seems to be an attempt to assist equity traders in estimating fair values. Such information does not appear to support the recorded balances, and certain information appears to be proprietary.

In light of the constituent responses to the 2010 Proposal, ABA does not believe that FASB intends to expand fair value accounting. While the ED narrows the various classification and measurement bases for various financial assets, the different aspects of the ED, when taken together, will expand the use of fair value for common debt instruments, will be costly to comply with, and will not provide more decision-useful information for investors in commercial banks.

Recommendations

FASB has taken significant steps since the beginning of the financial crisis to address the major concerns that constituents have had with bank financial reporting:

- **FASB Staff Position FAS 115-2 and FAS 124-2** *Recognition and Presentation of Other-Than-Temporary Impairments* addressed one of the major concerns about accounting for debt securities was other-than-temporary impairment (OTTI). The primary problem was that, with no transparency, both market and credit-related declines in value were inappropriately recorded in income for debt securities that are expected to be held for the long term. This was repaired by segregating OTTI declines that were market-related (and recording them in

OCI) from declines that were credit-related (and recording them in income). The FSP also improved overall credit loss recognition for debt securities. A remaining issue is the ability to record OTTI recoveries, which, experience has demonstrated, does occur.

- **FASB Statement No. 166** *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* and **FASB Statement No. 167** *Amendments to FASB Interpretation No. 46(R)* addressed the perceived credit risk and leverage resulting from securitized assets, by consolidating assets that had previously been accounted for off-balance sheet.

- **Accounting Standards Update (ASU) 2010-20** *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* added significant credit quality disclosures related to loans and other receivables. Significant transparency related to credit risk is now provided.

- **ASU 2011-03** *Reconsideration of Effective Control for Repurchase Agreements* and **ASU 2009-16** *Accounting for Transfers of Financial Assets* addressed disclosures and perceived loopholes in determining whether certain transfers qualify as secured borrowings. In other words, they addressed whether leverage risk was appropriately reflected.[4]

An advantage of this ED is the simplification of what both bankers and investors believe to be one of the most confusing areas accounting for loans: income recognition for purchased credit-impaired (PCI) assets. We strongly support this change. Further, the alleviation of "tainting" restrictions is a significant improvement compared to current principles. However, given that FASB has addressed these major areas of perceived weakness in accounting standards[5], we believe relatively little additional change is needed for classification and measurement. We acknowledge that the current "clearly and closely related" rules relating to embedded derivatives can be cumbersome to administer. However, they are now relatively well-understood by bankers, and we are unaware of significant problems that bank investors have had in understanding the related risks of hybrid instruments. The SPPI test opens a plethora of questions about how it should be applied to the wide variety of financial instruments and banking industry practices and bankers are concerned that a very large amount of implementation guidance will be required to interpret the many different terms existing in common lending products.

We know that the Board adopted the SPPI test, which currently exists in International Financial Reporting Standards No. 9[6], rather late in the deliberative process prior to the release of the ED. This leads us to wonder whether the decision may have been related to an attempt to converge rather than a targeted improvement in US GAAP. Although we strongly disagree with the SPPI

[4] An exposure draft is also currently outstanding that is continuing to address the similar issues.

[5] Of course, ABA supports FASB's current efforts to address impairment accounting.

[6] Though approved by IASB, IFRS No. 9 has yet to be widely adopted.

test requirement and propose that it be omitted from the final standard, if the FASB chooses to retain it, we recommend the following:

1. Eliminate the "solely" in SPPI or modify it to ensure that amortized cost is appropriate for common lending practices that are responsive to credit risk, interest rate risk, and risks related to liquidity, basis, foreign exchange, servicing, and prepayment.

    a. Terms with interest or foreign exchange rate basis differences should qualify for amortized cost, and no analysis should be required to determine whether more than insignificant variability is introduced.

    b. Instruments with leverage and so-called "punitive" rates also should not automatically fail the SPPI test if the terms or practices recognize relative increases in credit, liquidity, or interest rate risks.[7] Overall, the emphasis on an "appropriate rate of return" that "represents compensation for the time value of money and the credit risk" must be reevaluated.

    c. Eliminate the requirement that credit risk in a beneficial interest of a securitized financial asset must be equal to or lower than that of the underlying pool of assets. The SPPI as proposed allows lower than credit quality bonds to be recorded at amortized cost, while requiring FVNI for higher-rated, non-senior securitized tranches. Bankers normally have neither the information to "look through" to the underlying assets after the initial securitization, nor the current ability to compare the credit quality of many non-senior tranches to the total structures.

    The impact of the SPPI test is vast and the amount of ongoing work to be required is expected to be consistent with current embedded derivative requirements. If the SPPI test is used, the definition should be changed to allow "the primary cash flows result from payments or recoveries responsive to risks in the collection and servicing of principal and interest." If the Board cannot agree on the specifics of how such changes can be implemented, we recommend omitting the SPPI test and maintaining the current "clearly and closely related" principle, along with the related bifurcation requirements.

2. Recognize that the business models for loans are different from those related to debt securities by either maintaining the current "two bucket" classification for loans and continuing the current reclassification rules for loans or allowing unrestricted reclassification for all assets. Disclosure of transfers and sales by holding period will allow financial statement users to differentiate activity that is within the realm of normal mortgage banking

[7] ABA disagrees with the automatic failure of the SPPI criterion related to a "punitive" rate, which would occur if an interest rate that is higher than market is charged to a borrower that is unable to become a publicly-traded entity. Becoming a publicly-traded entity often allows companies access to other forms of capital that can reduce credit risk. Whether the "punitive" rate is at a market rate or not should not the determining factor in the decision about how the bank accounts for the loan. As written, the proposed SPPI principle would require virtually all loans that are not at the market rate to require in-depth SPPI analysis.

(for example, sales related to unseasoned loans) from those that might be related to credit risk management (for example, sales related to seasoned loans).

3. Omit the fair value disclosure requirements for public companies of amortized cost assets. While maintaining the current related disclosures for all banks, allow the "entrance price" calculations to be used.

4. Omit the disclosures related to core deposits, considering how such information may or may not support the recorded balances and may be proprietary.

5. Expand the fair value option to include situations that would significantly reduce or eliminate an accounting mismatch between assets and liabilities.

6. Approve the following proposals within the ED:

    a. Reflect changes in "own credit" (instrument-specific credit risk related to a financial liability accounted for at FVNI because of the fair value option) within OCI. This would avoid the illogical result of recording profits when a credit rating is lowered. It is reasonable and responsive to user needs.

    b. Account for purchased credit-impaired financial assets the same as other loans and securities. This not only will simplify operational processes at banks, but also provide investors with information they understand.

    c. Alleviate the "tainting" restrictions that have developed within current GAAP related to sales of assets accounted for at amortized cost. Most constituents would agree that the current standards go too far in restricting the activity of financial institutions to manage their investment portfolios. While a tainting notion will likely develop through industry practice over time, we believe it is more appropriately addressed at this level, as tainting will likely be based on specific facts and circumstances and, thus, a big improvement over the current standard.

    d. Allow alternative measurement for nonrecourse financial liabilities in order to match the related assets. Companies that maintain assets on their books that are linked to specific liabilities (for example, securitized assets that are consolidated) should be allowed to link to these assets in a way to reflect the true risks of these arrangements.

7. Initiate a new project that addresses the fair value standard as it relates to business combinations. The current standard unnecessarily drains capital from the banking industry because of inappropriate valuation discounts that are required on most loans.

We believe that if the standard is approved as is, at least three years would be required to design processes that evaluate the SPPI as well as to determine how loans will be classified. This time period will also be used for educating and advising investors about the new standard, the impact of the standard, and expectations going forward. With this in mind, we recommend that the effective date be the latter of three years or the effective date of the new credit loss standard. We anticipate that many instruments may no longer require an allowance for credit losses as a result of this ED – because they will be reported at market value – which may influence the design of credit loss estimation systems.

The following pages include detailed comments and concerns related to the ED, as well as answers to specific questions posed in the ED.

Thank you for your attention to these matters and for considering our views. 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

Donna J. Fisher

Appendix A: Specific Detailed Comments

Changes Recommended to the Proposals in the Exposure Draft (ED)

The SPPI principle should be eliminated or modified to include customary lending terms

ABA supports accounting that is based on the business model: instruments managed for fair value and trading purposes should be accounted for at fair value, while those managed for long-term investment in order to collect the contractual cash flows should be accounted for at amortized cost, with a vigorous impairment model. Such an accounting model reflects how the entity will generate its future cash flows, which is key information for investors.

The ED requires that a "cash flow characteristics" test be performed prior to a business model test to determine classification of financial assets into one of three classifications:

- Amortized cost (AC),
- Fair value accounting, with changes in fair value recorded through other comprehensive income (FVOCI), or
- Fair value accounting, with changes in fair value recorded through net income (FVNI).

The financial asset is classified as FVNI unless the asset passes the cash flow characteristics test and is managed within the qualifying business models to qualify for AC or FVOCI accounting.

With this in mind, ABA urges FASB to eliminate the SPPI the contractual cash flow characteristics criterion – that the contractual terms of the financial asset must give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding in order to qualify for AC or FVOCI. Along with the inability to bifurcate hybrid instruments by their respective characteristics, as well as the requirement to classify into FVNI any asset that has not passed the cash flow characteristics test, we believe that the test will lead to many unintended consequences, including requiring many more assets to be classified as FVNI than the Board has intended and a significant increase in compliance costs at all banks, both resulting in reconsideration by many banks – small and large – in participating in many lending markets. This obviously will limit the availability of credit in markets in which large institutions do not participate (smaller banks will reduce such offerings, since the compliance costs will be prohibitive), but also will increase the cost of such credit, due to the capital buffers required to address the fair value volatility.

ABA understands the desire to reflect only "vanilla" loans and debt securities within the AC or FVOCI categories. However, most lenders believe that terms within the "vanilla" designation generally respond to changes in credit risks, interest rate risks, as well as the liquidity, foreign exchange, and servicing risks. As a result, loans that include leverage or differences in interest rate or foreign exchange bases should not disqualify an instrument from amortized cost accounting[8].

ABA agrees that interest rates charged that are linked neither to interest nor exchange rates, such as non-financial commodity indices and equities introduce variability that are inconsistent with the notion of principle and interest[9]. The problems with the current definition of SPPI (including the examples within the implementation guidance) are the comparisons to "market bases", "benchmarks", and "reasonable compensation" for "more than insignificant" differences. This creates two particular issues:

1. Banks will be required to produce cumbersome documentation in supporting the SPPI notion across a wide range of products. This will particularly put community banks at a disadvantage, and we assume that these products, which are meant to address borrower needs, will be avoided by these institutions.

2. Inconsistencies will arise that will skew investor understanding of risk within the financial statements. Namely, assets in FVNI may often present less credit risk than those accounted for in AC or FVOCI. For example,

    a. Many less-than-investment grade bonds may be accounted for in AC, while higher rated assets may require FVNI. This is especially true for structured securities when the credit rating of the specific tranche is less than that of the entire securitization entity.

    b. Though credit risk is the largest concern of investors in understanding overall risk and volatility, interest and foreign exchange basis risks can often fail the SPPI test.

    c. Terms related to borrower performance that often impact the credit rating (net income, for example) specifically fail the SPPI test.[10]

    d. Cash flows within securitization structures, whether they derive from derivatives that absorb portions of basis risk, purchase discounts, or clean up calls, may disqualify relatively common securities from AC/FVOCI treatment.

[8] We believe that even "more than insignificant" leverage, etc. still addresses the customary risks that bankers assume. Any kind of threshold that assumes a "modified economic relationship" is not operational. While "the market" often directs pricing, rates and terms are often based on "what the customer can bear" and are influenced by the price of other products and services that are provided to the borrower, which normally includes a consideration of expected servicing income that is embedded in the instrument.

[9] With this in mind, ABA is concerned that equity stakes granted in a loan restructuring could cause an SPPI failure. Such equity stakes are often of nominal value and are accepted merely to recover the original loan balance.

[10] There are conflicting statements in the ED related to interest rate resets that could be responsive to credit risk. Paragraph 825-10-25-20a indicates that it can be determined only at initial recognition, whereby paragraph 825-10-55-47 indicates that credit risk spreads may vary during the life of the instrument and still qualify as SPPI.

e. Nominal equity stakes, whether through participations, equity kickers, or those received in troubled debt situations, require FVNI treatment.

We believe that more guidance might be possible to clarify the applicable situations. However, the problems are rooted in the strict definitions surrounding SPPI and its emphasis on benchmark or market rates (whether interest rates or compensation rates). We fear that the questions surrounding the implementation of SPPI will be needlessly vast. Much work will be required to attain accounting that does not necessarily reflect the risks involved. As a result, we believe the current model should be retained. It is tested and provides useful information that reflects the true variability that is in a portfolio. If FASB insists that SPPI test be retained, it should be replaced by a principle whereby "the primary cash flows result from payments or recoveries responsive to risks in the collection and servicing of principal and interest".

We believe that this language will also include most subordinate tranches in a structured security to comply with SPPI. Non-senior tranches of structured securities are assumed to provide leverage. The proposal to require such tranches to be at a lesser or equal credit risk of the whole structure is not only very demanding operationally (many believe that rating the whole structure will be very difficult) but also will inappropriately require FVNI treatment on many high quality (though not senior) securities. We also anticipate that, unless there are significant changes to information provided within the market for securitized assets, most instruments bought on the secondary market will require FVNI, due to the inability to satisfactorily be able to look through to the actual underlying assets.

As credit quality is the risk that supplies the greatest variability within debt instruments, identifying variability due to leverage and other routine factors can be satisfied through credit quality disclosures. The variability that FASB seeks to move into FVNI should be based on non-customary lending terms. We believe that such a change in the wording as noted above, reasonably addresses the key risks while being operational to all institutions.

Reclassification should be allowed, reflecting the realities of the banking business

The ED proposes a unified model for both loans and debt securities that generally reflects the model introduced for securities within FASB Statement No. 115. At first glance, this model appears reasonable for loans, as loans currently are classified as either held for sale or as held for investment. The proposal, however, to disallow reclassification of assets (whether they are loans or debt securities) makes sense for securities. However, two aspects of common banking practice make this new limitation for loans impractical.

1. Loans originated by banks that sell portions of their loan production (though not identified at the time of origination) will be subject to arbitrary classification.[11]

[11] The proposal in paragraph 825-10-25-30 for companies to allocate percentages of their loans between the three classifications is operationally complex and may also be of questionable value to investors.

2. Loans are commonly sold to manage credit concentrations.[12]

As a result of the reclassification restrictions, a large percentage of loans held for long-term investment will likely require FVOCI or FVNI classifications. As constituents noted in 2010, fair value reporting for loans held for investment is not appropriate.

It is evident that, from a business model perspective, loans are different from debt securities. The general "hold/make available/trade" model for securities does not exist with loans. Loans that are held for sale are not part of a trading operation, but are normally the production of mortgage banking operations. Typical loans held for long-term investment are not meant to be sold for liquidity or asset/liability matching purposes (as securities are). They are meant to be held long-term.

With this in mind, we recommend that either the current loan classification standard that allows reclassification be retained[13] or that full reclassification be allowed for all assets. Disclosure related to reclassification and sales by holding period will allow investors to evaluate whether activity is in accordance with the overall lending business model. Those loans reclassified or sold within a year after origination would be assumed to be a product of the mortgage banking operation or to address a credit concentration issue resulting from new loan production. Those loans sold after would be subject to more scrutiny related to the business model.

Omit the fair value disclosure requirements for public companies of amortized cost assets

The ED proposes requiring, for publicly-held companies, parenthetical disclosure on the balance sheet of the fair value of financial assets accounted for at amortized cost. The proposal also discontinues the "entrance price" notion currently used by most banks as part of their fair value disclosures and requires Level 3 footnote disclosures for these assets.

These requirements will greatly increase costs for two reasons:

1. The exit price notion of fair value disclosures requires significantly more work (both by the bank and for audit) than the entrance price method that is currently used by the vast majority of banks in the U.S. This work is borne in order to estimate various market-based discount rates, including liquidity discounts existing in the many specific local markets across the U.S.

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[12] Sales due to management of credit concentrations are specifically noted to not be consistent with amortized cost classification. While this is an issue for banks of all sizes, we believe this could adversely impact community bankers the most, as loan participations are often used as a tool used to manage individual borrower risk positions.

Many bankers use participations on lines of credit that define a cap, whereby all draws over the cap are sold to a participant. The ED appears to put the amortized cost status of the original line of credit in doubt, which we do not believe is appropriate.

[13] ABA supports a proposal to discontinue accounting for loans held for sale with the "lower of cost or fair value" method. Measuring these assets within FVNI is an appropriate change.

2. The new Level 3 fair value disclosures in the notes to the financial statements, which have not been previously required, will take significant time to develop.

Regarding these new requirements, we question whether incrementally valuable and decision-useful information will be provided. This will have the largest impact on publicly-held community banks,[14] as they operate in markets that will have the largest liquidity discounts (this lack of liquidity in local markets is the very reason that community banks are chartered to address). Further, the vast differences in local markets will maintain the inconsistency of fair values between banks today.

If the intent of FASB is to satisfy that minority of financial statement users who will use the information on understanding realizable value if liquidity is an issue (as noted in the ED), we do not believe these users will be satisfied, as liquidity issues precipitate the very "fire sale" prices that are specifically exempted from the definition of fair value. Further, those who compare changes in loan fair values as a reasonability analysis of the allowance for loan losses would be better served by using the entrance price method. With this in mind, ABA recommends that FASB omit these requirements from the final standard. They are not needed, will provide no better decision-useful information, and will be costly to comply with and to audit.

Omit the requirement to disclose core deposit information

The ED proposes to require disclosure by publicly-held companies of a core deposit liability balance, its implied weighted-average maturity period, and an estimated-all-in-cost-to-service rate. We appreciate that such information can facilitate estimates of a core deposit intangible. However, we strongly oppose such disclosures in audited financial statements.

- None of the disclosed information supports any amount presented on the financial statements, as a core deposit is merely a uniquely management-specified metric[15] that is included among deposit liabilities as a whole.

- Concepts such as the weighted-average maturity period and estimated-all-in-cost-to-service rate are internally generated and highly judgmental. The costs of audit will be significant for little user benefit. Further, the all-in-cost-to-service rate is considered proprietary by banks and may be comparable to requiring the disclosure of the variable costs of a manufacturer's largest-selling product.

We acknowledge that a strong core deposit base can lead to advantages in future funding costs (and thus, impacting future cash flows). However, such information appears to be inappropriate for inclusion in the financial statements and more appropriate for inclusion within Management's Discussion and Analysis. With this in mind, we recommend, along with omitting such a

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[14] ABA estimates that approximately 150 publicly-held community banks that have assets less than $500 million would be subject to this requirement, along with 600 similarly-sized banks that are owned by publicly held holding companies. Collectively, these institutions carry approximately $175 billion in assets.

[15] ABA notes that banks often define a "core deposit" differently than how the term is defined within the ED.

disclosure from the final standard, that further coordination with the Securities and Exchange Commission on how such information should be addressed for investors.

Expand the fair value option

While the proposed restrictions on usage of the fair value option (FVO) appears to allow the FVO in the majority of circumstances in which banks would elect the FVO, we believe the restriction that the entity "manages the related net exposure on a fair value basis" and that "the entity provides information on a net exposure basis to its management" to be overly narrow and cumbersome – thus, defeating the purpose of the FVO. With that in mind, ABA recommends that FASB adopt similar language as the IASB within IFRS 9, which allows the FVO to include situations that "would significantly reduce or eliminate an accounting mismatch between financial assets and liabilities".

Comments Related to Proposals that ABA Supports

Reflect fair value changes in "own credit" within other comprehensive income

Companies should not profit when their credit rating falls. With this in mind, the proposal to reflect such "own credit" changes within FVOCI (when the related financial liabilities are accounted for through the fair value option) is perfectly appropriate. Investors and banking regulators also eliminate such amounts from regulatory capital calculations, and regulators are expected to upon implementation of Basel III reforms. Therefore, the proposal is reasonable and responsive to user needs. We recommend that companies be allowed to adopt this provision upon issuance of the final standard.

Account for purchased credit-impaired financial assets the same as other loans and securities

The current standard to account for purchased credit-impaired (PCI) loans is cumbersome and confusing for bankers and investors alike. No one likes the standard, as it not only is extremely complex to operationalize, it requires significant supplemental information to make sense of the results. The proposal effectively treats PCI loans as all other loans for the purpose of income recognition. This not only will simplify operational processes at banks, but also will provide investors with information they understand.

Alleviate the "tainting" restrictions related to sales of assets accounted for at AC

The evolution of the "tainting" notion within the current "held-to-maturity" classification has created operational nightmares for many institutions and has created restrictions that ABA believes have gone far beyond the intent of the Board. With this in mind, we support the Board's proposal to eliminate the concept and require sufficient disclosure of sales within the amortized cost classification. We believe that a tainting notion may develop over time. However, we also believe that such a tainting notion will be based on facts and circumstances and allow significantly more flexibility for banking institutions than currently exist.

Allow alternative measurement for nonrecourse financial liabilities in order to match the related assets

A significant impact of FASB Statement 167, which required consolidation of many securitization entities, was not only that billions of dollars of assets were added to balance sheets, it is that liabilities (representing third-party interests in the related securities) were also recorded and that the accounting for these liabilities was totally independent of the assets. As a result, projected cash shortfalls of the securities that would be borne by the third-party security holders are reflected in the allowance for loan and lease losses, yet cannot offset the related secured borrowing liabilities.[16] In other words, the bank reports losses for which it will not be liable for.

Companies that maintain assets on their books that are linked to specific liabilities (for example, securitized assets that are consolidated) should be allowed to link to these assets in a way to reflect the true risks of these arrangements. FASB has recognized this by proposing that the related liabilities be measured on the same basis of the assets. ABA supports this proposal.

Comment to start a new project

Initiate a new project that addresses the fair value standard as it relates to business combinations.

Current accounting standards for business combinations are set up to needlessly drain billions of dollars of capital from the banking industry. The requirement to value all assets and liabilities (related to this issue, loans) at "fair value" results in loans that are severely discounted for financial statement purposes and goodwill recorded. Since goodwill is not counted in regulatory capital, two well-capitalized banks can merge, yet be required to raise additional capital solely because of the accounting rules. Going forward, then, yields are artificially inflated because of the discounted basis from which they are derived. As a result, not only is capital drained, but the operating results are distorted. Is this good accounting?

We know that FASB is aware of this issue, as the problem has been noted by FASB's Investor Technical Advisory Committee. ABA urges FASB to immediately initiate a project to address this. With the implementation of requirements of the Dodd-Frank Act, many expect there to be an acceleration of consolidation of community banks across the country. Many also believe that this consolidation has not yet started because of the additional capital that is required to consolidate. Community banks are particularly impacted by this because they specifically hold loans that are more illiquid than those held by other banks.

We believe FASB can address this issue in various ways. Implementation of FASB Statement No. 141(R) (now referred to as Accounting Standards Codification Topic 805), which requires

[16] Technically, this is a timing difference. However, contingent gains on liabilities, for practical purposes, are able to be recorded only upon ultimate dissolution of the security.

all assets of the acquired entity to be measured at fair value, is generally thought to have precipitated this problem. Statement 141(R) effectively assumes that banks that enter into a business combination do so to extract fair values out of assets and will manage those assets based on the fair values. That is normally not the case[17]. Therefore, we encourage the Board to pursue whether modifications to this standard are appropriate. However, we also believe the standard related to fair value also should be examined.

Current fair value standards do not adequately address loans in the banking industry. Key questions related to loans remain:

- Is there a "highest and best use" for loans? Should loans that are subject to a "merger of equals" and going to be managed no differently after the merger than before the merger be subject to the same liquidity, risk, and cost of capital discounts that are applied by other so-called "market participants"?

- Should a merger that is arranged or approved by a regulatory authority impact how fair values are derived? Within such a circumstance, the number of applicable "market participants" would be limited (and have similar cost of capital requirements). Values based on non-merger-related transactions do not appear to be appropriate.

FASB may believe that the fair value standard is appropriate, but the implementation is ineffective. If that is the case, we must ask whether a standard that cannot be effectively implemented is of high quality. We do not believe so. We, therefore, recommend such a review of the current standards be started as soon as possible.

[17] FASB has recently realized this and has proposed modifications to how purchased credit-impaired loans are accounted for within this ED and how they are presented within FASB's *Expected Credit Losses* ED. There still exist inconsistencies with how non-impaired loans are presented because of FASB Statement No. 141(R) which ABA has recommended changing within the comment letter related to the *Expected Credit Losses* ED. However, the problem of determining and recording the value of loans still remains. This is the issue being addressed within this comment.

APPENDIX B: Responses to Selected Questions from the Exposure Draft

Questions for All Respondents

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments should be included or excluded from the guidance in this proposed Update and why?

ABA Response: ABA believes FASB should address how loans are valued within a regulated industry business combination. Current accounting standards for business combinations are set up to needlessly drain billions of dollars of capital from the banking industry. The requirement to value all assets and liabilities (related to this issue, the valuation of loans is the most significant category) at "fair value" results in loans that are severely discounted for financial statement purposes and goodwill recorded. Since goodwill is not counted in regulatory capital, two well-capitalized banks can merge, yet be required to raise additional capital solely because of the accounting rules. Going forward, then, yields are artificially inflated because of the discounted basis from which they are derived. As a result, not only is capital drained, but the operating results are distorted.

We know that FASB is aware of this issue, as the problem has been noted by FASB's Investor Technical Advisory Committee. ABA urges FASB to immediately initiate a project to address this. With the implementation of requirements of the Dodd-Frank Act, many expect there to be an acceleration of consolidation of community banks across the country. Many also believe that this consolidation has not yet started because of the additional capital that is required to consolidate. Although this accounting problem applies to all sizes of banks, it tends to have a larger impact on community banks because they typically hold loans that are more illiquid than those held by other banks.

We believe FASB can address this issue in various ways. Implementation of FASB Statement No. 141(R) (now referred to as Accounting Standards Codification Topic 805), which requires all assets of the acquired entity to be measured at fair value, is generally thought to have precipitated this problem. Statement 141(R) effectively assumes that banks that enter into a business combination do so to extract fair values out of assets and will manage those assets based on the fair values. That is normally not the case.[18] Therefore, we encourage the Board to pursue whether modifications to this standard are appropriate. Additionally, the standard related to fair value also should be examined.

Current fair value standards do not adequately address loans in the banking industry. Key questions related to loans include:

[18] FASB has recently realized this and has proposed modifications to how purchased credit-impaired loans are accounted for within this ED and how they are presented within FASB's *Expected Credit Losses* ED. There still exist inconsistencies with how non-impaired loans are presented because of FASB Statement No. 141(R) which ABA has recommended changing within the comment letter related to the *Expected Credit Losses* ED. However, the problem of determining and recording the value of loans still remains. This is the issue being addressed within this comment.

- Is there a "highest and best use" for loans? Should loans that are subject to a "merger of equals" and going to be managed no differently after the merger than before the merger be subject to the same liquidity, risk, and cost of capital discounts that are applied by other so-called "market participants"?

- Should a merger that is arranged or approved by a regulatory authority impact how fair values are derived? Within such a circumstance, the number of applicable "market participants" would be limited. Values based on non-merger-related transactions do not appear to be appropriate.

  FASB may believe that the fair value standard is appropriate, but the implementation is ineffective. If that is the case, we must ask whether a standard that cannot be effectively implemented is of high quality. We do not believe so. We, therefore, recommend such a review of the current standards be started as soon as possible.

Recognition

Questions for Users

Question 3: The proposed amendments would require an entity to classify financial assets into the appropriate subsequent measurement category (that is, at amortized cost, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at fair value with all changes in fair value recognized in net income) on the basis of the contractual cash flow characteristics of the instrument and the business model within which financial assets are managed. Does the classification of financial assets based on the cash flow characteristics and the business model assessment provide decision-useful information? If yes, how will this classification influence your analysis of the entity? If not, why?

ABA Response: Investors believe that loans with most common lending terms should not be marked to market with changes recorded through net income. It is generally understood that derivatives should be marked to market. However, they are concerned that mark to market accounting could be significantly expanded with the proposal.

Questions for All Respondents

Question 4: Do the proposed amendments appropriately convey the principle associated with the contractual cash flow characteristics assessment? If not, why? What would you propose instead?

ABA Response: The SPPI test is too strict and would force many loans and securities to be marked to market without justification. It appears to miss the basic point that often other elements of risk and return (for example, the servicing rights) are a necessary element of the instrument. The amount of ongoing work to be required is expected to be consistent with current embedded derivative requirements.

If the SPPI test is used, the definition should be changed to allow "the primary cash flows result from payments or recoveries responsive to risks in the collection and servicing of principal and interest." If the Board cannot agree on the specifics of how such changes can be implemented, we recommend omitting the SPPI test and maintaining the current "clearly and closely related" principle, along with the related bifurcation requirements.

Question 5: The proposed amendments define *principal* as the amount transferred by the holder at initial recognition. Should the definition of *principal* be expanded to include repayment of the principal amount at maturity or other settlement? If so, what instruments would fail (or pass) the contractual cash flow characteristics criterion as a result of this change?

ABA Response: See response to Question 4.

Question 6: Do the proposed amendments contain sufficient application guidance and illustrations on implementing the cash flow characteristics assessment? If not, why?

ABA Response: ABA believes that the illustrations are sufficient to convey that the SPPI test is too strict and would force too many loans and securities into a mark to market (FVNI) accounting without justification. At a minimum, significant work will be required to address each product.

Question 7: Should a financial asset with a contractual term that modifies the economic relationship (see paragraphs 825-10-55-17 through 55-20) between principal and interest be considered to contain cash flows that are solely payments of principal and interest? Should this be the case if, and only if, the contractual cash flows could or could not be more than insignificantly different from the benchmark cash flows as discussed in paragraph 825-10-55-19? If not, why? What would you propose instead?

ABA Response: ABA believes that terms such as leverage, basis, and foreign exchange risks and provisions that address expected servicing fees are common terms that should not disqualify an instrument from being SPPI.

Question 8: Do the proposed amendments contain sufficient application guidance in paragraphs 825-10-55-17 through 55-20 on assessing a modified economic relationship? If not, why?

ABA Response: Consistent with question 6, ABA believes that the guidance is sufficient to convey that the SPPI test is too strict and would force too many loans and securities into a mark to market (FVNI) accounting. At a minimum, significant work will be required to address each product.

Question 9: For beneficial interests in securitized financial assets, the proposed amendments would require an entity to look through to the underlying pool of instruments in determining whether the tranche contains payments of solely principal and interest. Do you agree with this look-through approach? If not, why? What would you propose instead?

ABA Response: ABA believes that the vast majority of tranches in a structured security would require FVNI accounting, which is not appropriate. Other than at issuance, it is normally not possible to "look through" the securitization to see all the specific assets therein. So, this would potentially cut off the secondary market for such instruments. Further, since individual tranches are normally rated, and not the whole security, it is likely that most banks will not be able to determine whether the credit risk of the tranche held is higher or lower than total security. To require this does not make sense.

FASB Statement No. 167 effectively causes the most leveraged of the tranches to remain on the securitizer's balance sheet as a part of the entire security (recorded as a loan). This seems to take care of most of the Board's concern (combined with the principles in the credit loss exposure draft), if the concern is to appropriately reflect the credit risk of the security.

ABA believes that there should be no special tests in the final classification and measurement standard related to securitized assets that are not currently applicable in GAAP.

Question 10: Do the proposed amendments appropriately convey the principle associated with the business model assessment? If not, why? What would you propose instead?

ABA Response: The restriction of selling in response to credit concentration management will require most loans to be classified FVOCI, which does not convey the business model. While the proposed definition appears to adequately address most mortgage banking operations, we believe that many loans that are originated by these entities and eventually determined to be held for the foreseeable future will be inappropriately classified as FVOCI, due to the limitations on reclassification.

FASB should recognize that the business models for loans are different from those related to debt securities by either maintaining the current "two bucket" classification for loans and continuing the current reclassification rules for loans or allowing unrestricted reclassification for all assets. Disclosure of transfers and sales by holding period will allow financial statement users to differentiate activity that is within the realm of normal mortgage banking (for example, sales related to unseasoned loans) from those that might be related to credit risk management (for example, sales related to seasoned loans).

Question 11: Do the proposed amendments provide sufficient application guidance and illustrations on how to distinguish among the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the proposed guidance provided to describe those business models? If not, why?

ABA Response: Application guidance is needed for mortgage bankers that commonly sell a percentage of their originated assets. The proposal is unclear on how the requirements would be applied, making it difficult for us to understand whether it is operational. Specifically, it appears that such mortgages would be automatically classified as FV-OCI, since the loans could be held or sold. However, the ED also indicates that portions of loans could be classified in one category, with the remaining portion classified in a different category.

Question 12: Should the classification and measurement model for financial instruments contain an explicit tainting notion or should it rely on the principle and exercise of professional judgment? Why?

ABA Response: There should be no tainting notion, as occasional sales and reclassifications are performed as a normal part of a banking business.

Initial Measurement

Questions for All Respondents

Question 14: Do you agree with the initial measurement principles for financial instruments? If not, why?

ABA Response: ABA believes they are intended to be consistent with current treatment and this appears appropriate.

Subsequent Measurement

Questions for Users

Question 15: The proposed amendments would eliminate the unconditional fair value option (for financial instruments within the scope of this proposed guidance) in existing U.S. GAAP and, instead, permit an entity to elect to measure at fair value, with all changes in fair value recognized in net income, all of the following:

a. A group of financial assets and financial liabilities if the entity both:
    1. Manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis
    2. Provides information on that basis to the reporting entity's management.
b. Hybrid financial liabilities that meet certain prescribed criteria.
c. Financial assets that meet the contractual cash flow characteristics criterion and are managed within a business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets (in accordance with paragraph 825-10-25-25(b)).

Do these options provide decision-useful information? If not, why?

ABA Response: While the proposed restrictions on usage of the fair value option (FVO) appear to allow the FVO in the majority of circumstances in which banks would elect the FVO, we believe the restriction that the entity "manages the related net exposure on a fair value basis" and that "the entity provides information on a net exposure basis to its management" is overly narrow and cumbersome – thus, defeating the purpose of the FVO. With that in mind, ABA recommends that FASB adopt similar language as the IASB within IFRS 9, which allows the FVO to include situations that "would significantly reduce or eliminate an accounting mismatch between financial assets and liabilities".

Questions for All Respondents

Question 16: Should financial liabilities subsequently be measured at amortized cost, unless certain exceptions are met? If not, why?

ABA Response: ABA generally agrees that financial liabilities should be measured at amortized cost, subject to how they are managed (as noted in Question 15).

Question 17: The proposed amendments would require a nonrecourse financial liability that is settled with only the cash flows from the related financial assets (see paragraph 825-10-35-11) to be measured on the same basis as those assets. Do you agree with the proposed amendments? If not, why? What would you propose instead?

ABA Response: A significant impact of FASB Statement 167, which required consolidation of many securitization entities, was not only that billions of dollars of assets were added to balance sheets, it was that liabilities (representing third-party interests in the related securities) were also recorded and that the accounting for these liabilities was totally independent of the assets. As a result, projected cash shortfalls of the securities that would be borne by the third-party security holders are reflected in the allowance for loan and lease losses, yet cannot offset the related secured borrowing liabilities. In other words, the bank reports losses for which it will not be liable.

Companies that maintain assets on their books that are linked to specific liabilities (for example, securitized assets that are consolidated) should be allowed to link to these assets in a way to reflect the true risks of these arrangements. FASB has recognized this by proposing that the related liabilities be measured on the same basis of the assets. ABA supports this proposal.

Question 21: Under the amendments in this proposed Update, hybrid financial assets would not be required to be analyzed for bifurcation under Subtopic 815-15 and would be assessed in their entirety on the basis of the proposed classification requirements. In contrast, hybrid financial liabilities would be assessed for bifurcation and separate accounting under Subtopic 815-15, and the financial liability host contract would be subject to the proposed amendments. Do you agree with this proposal? If not, why? What would you propose instead?

ABA Response: ABA believes that bifurcation for hybrid financial assets should be maintained, as it helps both bankers and investors in understanding what variability there is in an instrument.

Presentation

Questions for Users

Question 23: The proposed amendments would require public entities to parenthetically present fair value for items measured at amortized cost on the face of the statement of financial position. Does that presentation requirement provide decision-useful information? If not, why? What would you propose instead?

ABA Response: The ED proposes requiring, for publicly-held companies, parenthetical disclosure on the balance sheet of the fair value of financial assets accounted for at amortized cost. The proposal also discontinues the "entrance price" notion currently used by most banks as part of their fair value disclosures and requires Level 3 footnote disclosures for these assets. Our primary concern is the idea of placing such significance on an unreliable disclosure and whether these new requirements can pass a costs vs. benefits test.

These requirements will greatly increase costs for two reasons:

3. The exit price notion of fair value disclosures requires significantly more work (both by the bank and for audit purposes) than the entrance price method that is currently used by the vast majority of banks in the U.S. The new work that will be required will involve estimating various market-based discount rates, including liquidity discounts existing in the many specific local markets across the U.S.

4. The new Level 3 fair value disclosures in the notes to the financial statements, which have not been previously required, will take significant time to develop.

Regarding these new requirements, we question whether incrementally valuable and decision-useful information will be provided. The biggest impact will be on publicly-held community banks,[19] as they operate in markets that will have the largest liquidity discounts (this lack of liquidity in local markets is central to the community banking business). Further, the vast differences in local market liquidity will maintain the non-comparability of fair values between banks that exists today.

If the intent of FASB is to satisfy a minority of financial statement users who may use the information in order to understand realizable value if liquidity issues arise (as noted in the ED), we do not believe these users will be satisfied, as liquidity issues precipitate the very "fire sale" prices that are specifically exempted from the definition of fair value. Further, those who compare changes in loan fair values as a check on the reasonableness of the allowance for loan losses would be better served by using the entrance price method. With this in mind, ABA recommends that FASB omit these requirements from the final standard. They are not needed, will provide no better decision-useful information, and will be costly to comply with and to audit.

[19] ABA estimates that approximately 150 publicly-held community banks that have assets less than $500 million would be subject to this requirement, along with 600 similarly-sized banks that are owned by publicly held holding companies. Collectively, these institutions carry approximately $175 billion in assets.

Question 25: The proposed amendments would require an entity to separately present changes in fair value attributable to changes in instrument-specific credit risk in other comprehensive income for financial liabilities for which that entity has elected the fair value option. Would the proposed presentation requirement provide decision-useful information? If not, why? What would you propose instead?

ABA Response: Of all the criticisms that investors have with current accounting standards, the concept that a company profits when its credit rating falls is the most absurd. With this in mind, the proposal to reflect such "own credit" changes within FVOCI (when the related financial liabilities are accounted for through the fair value option) is perfectly appropriate. Banking regulators also eliminate such amounts from regulatory capital calculations. Therefore, the proposal is reasonable and responsive to user needs. We recommend that companies be allowed to adopt this provision upon issuance of the final standard.

Disclosures

Questions for Users

Question 27: The proposed amendments would require a public entity to provide disclosure of the core deposit liability balance, implied weighted-average maturity period, and the estimated all-in-cost-to-service rate by significant type of core deposit liability. Do you agree with the proposed disclosure requirement and, if so, how would you use that information? If not, what information should be provided and why? Is it appropriate not to require this information for nonpublic entities? 14

ABA Response: We appreciate that such information can facilitate estimates of a core deposit intangible. However, we strongly oppose such disclosures in audited financial statements for the following reasons:

- None of the disclosed information supports any amount presented on the financial statements, as a core deposit is merely a uniquely management-specified metric[20] that is included among deposit liabilities as a whole.

- Concepts such as the weighted-average maturity period and estimated-all-in-cost-to-service rate are internally generated and highly judgmental. The costs of audit will be significant for little user benefit. Further, the all-in-cost-to-service rate is considered proprietary by banks and may be comparable to requiring the disclosure of the variable costs of a manufacturer's largest-selling product.

We acknowledge that a strong core deposit base can lead to advantages in future funding costs (and thus, have an impact on future cash flows). However, such information appears to be inappropriate for inclusion in the financial statements and more appropriate for inclusion within

[20] Banks often define a "core deposit" differently than how the term is defined within the ED.

Management's Discussion and Analysis. With this in mind, we recommend, along with omitting such a disclosure from the final standard, further coordination with the Securities and Exchange Commission on how such information should be addressed for investors.

Transition and Open Effective Date Information

Questions for All Respondents

Question 30: Should an entity be permitted to early adopt only the proposed presentation requirements related to changes in instrument-specific credit risk for hybrid financial liabilities that would qualify for the fair value option under the proposed requirements? If not, why?

ABA Response: ABA supports the early adoption of the final provisions for those entities that have instrument-specific credit risk (own credit) for applicable fair value liabilities. However, entities should be able to early adopt other measures with the preapproval of their regulators. While this may hinder comparability between banks, we do not anticipate that a significant number of banks will opt to early adopt other aspects of the proposal.

Question 31: Should the effective date be the same for both public entities and nonpublic entities?

ABA Response: ABA believes that the effective date should generally be the same for both public and nonpublic entities, and sufficient implementation time should be provided for both. Publicly-available information (for example, call reports) enables comparability between entities. Such information is helpful to regulators, investors, and other users of bank financial statements.

Questions for Preparers and Auditors

Question 32: How much time is needed to implement the proposed guidance?

ABA Response: If the FASB approves the SPPI test, a minimum of three years will be required to implement the new standard. However, we recommend that implementation be coordinated with the effective date of the standard to be approved related to credit losses. As the results of the SPPI test will potentially limit the amount of assets that are subject to the credit losses model, such coordination is critical.