

May 30, 2013

Via Email: director@fasb.org

Leslie Seidman
Chairman
File Reference No. 2012-260
FASB
401 Merritt 7 / PO Box 5116
Norwalk, CT 06856-5116

Re: Proposed Financial Accounting Standards Board Exposure Draft Financial Instruments—Credit Losses (Subtopic 825-15) (the “Proposal”)

Dear Chairman Seidman:

The Risk Management Association (“RMA”) supports the Financial Accounting Standards Board’s (“FASB,” the “Board”) objective to reduce complexity and provide financial statement users with more useful information about the expected credit losses on financial assets and other commitments to extend credit held by a reporting entity at each reporting date, and we encourage the Board to continue addressing this topic. We also appreciate the outreach related to this topic performed by FASB Board members and staff, and we hope to continue to be an active participant in deliberations relating to credit loss accounting standards. However, we believe that there are inherent weaknesses and unintended consequences in the Proposal that compromise the Board’s objective.

Who We Are and the Context for Our Response

RMA is a 501(c) (6) not-for-profit professional association whose sole purpose is to advance the use of sound risk principles in the financial services industry. RMA has approximately 2,500 institutional members that include banks of all sizes, as well as nonbank financial institutions. The comments contained herein are informed by subject matter experts from member institutions of RMA’s Allowance for Credit Losses Working Group. These member institutions may submit responses on their own behalf, which may or may not conform to the response of RMA.

Our comments are limited to “held for investment loan assets” and do not address the unintended consequences and implications for securities. However, we do not support inclusion of securities as part of the current exposure draft process on impairment treatment on the basis that the current approach is not problematic and is well understood. Our response is submitted in the context of how the proposed changes will impact our member institutions’ ability to assess credit losses, as well as the financial impact of those changes. We feel that we are uniquely positioned to comment on this exposure draft because RMA is primarily concerned with accurate risk measurement and reporting from a perspective of bank practitioners who measure credit risk as a profession.



Response

Our concerns can be summarized into six broad areas:

- I. The language implies a “Life of Loan” impairment measurement concept that cannot be supported.
- II. The lack of convergence between GAAP and IFRS may put US-based financial institutions at a regulatory and competitive disadvantage due to the anticipated material increase in the amount of capital that will be needed to comply with the proposal. Additionally, the proposal acts as a disincentive to lending, especially the making of long-term loans, and thus creates systemic risk.
- III. In an attempt to address a concern of “too-little-too-late” the proposal has swung the pendulum to “too-much-too-soon.” As a result significant systemic volatility may be introduced.
- IV. The Proposal – principles based, will increase the use of judgment by management and thus may ultimately compromise comparability and consistency.
- V. The amount of effort and cost to comply with the proposal has been substantially underestimated, and, in certain cases, such as in community banking organizations, the changes may be challenging at best and impractical at worst. Additionally, several concepts provided in the Proposal are inherently flawed.
- VI. Other considerations in the Proposal are also discussed.

Specifically:

- I. The language implies a “Life of Loan” impairment measurement concept that cannot be supported.

In this section we discuss our concerns about the definition and use of “lifetime” expected losses; inability to forecast economic variables beyond a “foreseeable” duration; and operational concerns with anticipating lifetime losses on certain asset classes.

We believe that the foundation of a high quality impairment accounting standard ought to balance accurate loss provisioning with providing financial statement users with relevant, reliable and ultimately decision-useful information. We are concerned with the extent of the requirement to incorporate forward-looking information in estimating credit losses *over the entire contractual term* of financial assets. Although the Board recognized in the proposal that expected prepayments may affect the allowance for expected credit losses, we believe that the term “entire contractual term,” as currently used in 825-15-25-3, should be clarified since it may result in confusion as to whether an entity should determine expected credit losses based on contractual maturity, *expected* maturity (based on historical experience or forecasted expectations) or foreseeable life of a financial asset.

We agree that the reliability of the estimates used in external financial reporting diminishes as the forecast horizon increases, thereby reducing the usefulness of such information for users of financial statements. A reasonable and supportable forecast horizon that produces a more reliable estimate of expected credit losses would likely be defined as the “foreseeable future,” which we view generally to be a period of approximately 2-3 years. By requiring financial statement preparers to make assumptions beyond the



foreseeable future, comparability and consistency will be compromised. Depending on the class of financial asset and credit risk characteristics, the foreseeable future may be different by asset class. For example, the foreseeable future for corporate loans may be different than that of residential mortgage loans, depending on the attributes relevant to each type of financial asset. An industry letter signed by banks was recently submitted to FASB that supports a dual impairment model with a default impairment assumption for performing loans that would be the greater of 12 months or the period that is reliably estimable and predictable. We believe this solution addresses key concerns, results in meaningful estimates and is capable of implementation.

Lastly, by requiring the “possibility of loss and no loss but prohibition of the most likely outcome,” the Proposal creates challenges for models to pass validation requirements, and results will not back test, particularly for consumer models. This removes some level of sound judgment by prohibiting use of a most likely outcome. The Board should maintain flexibility in permitting the use of a wide range of outcomes and management's best estimate should be supported regardless of mean, median or mode.

FASB Statement No. 5, Accounting for Contingencies, includes in its basis of conclusions that “accounting accruals do not provide protection against losses.” We are concerned the Proposal compromises the fundamental accounting principle that losses are recorded when incurred, rather than when they are estimated to occur in the future. We hope that the FASB will reconsider this estimation of contractual lifetime losses, as it violates the matching principle of accounting by recognizing all the loss on Day 1 and revenue over the life of the asset, and will prevent convergence with the IASB (addressed below).

II. The lack of convergence between GAAP and IFRS may put US-based financial institutions at a regulatory and competitive disadvantage due to the anticipated material increase in the amount of capital that will be needed to comply with the proposal. Additionally, the proposal acts as a disincentive to lending, especially the making of long-term loans, and, thus, creates systemic risk.

While not intended, the life-of-loan accounting requirement, with no capital relief to domestic banks, will put them at a significant competitive disadvantage in the industry compared to international peers. Additionally, the lack of convergence increases both the operational and reporting complexity for those international banks operating in multiple domiciles.

Probability of default increases exponentially the longer the term of the paper. Banks will have no choice but to pass on the increased cost of credit for long-tenured paper to the customer, with the potential to significantly reduce lending activity. Systemic risk would rise as a result across the domestic financial industry.

While the FASB indicates that “the mission of the FASB is to establish and improve standards of financial accounting and reporting to provide decision useful information to *investors* and other users of financial reports” one of the primary drivers behind the FASB’s proposed impairment standard is the report of the Financial Advisory Group. This report reviews accounting standard setting in the light of the financial crisis. Accounting standards should also be considered in the light of the regulatory environment.

III. In an attempt to address a concern of “too-little-too-late,” the proposal has swung the pendulum to “too-much-too-soon.” As a result, significant systemic volatility may be introduced.



If the Proposal is implemented in its present form, current and forecasted economic conditions should be incorporated in the estimates, which should drive change in borrower behavior projections such that expected credit loss allowance levels vary in accordance with economic conditions. Small movements in economic conditions can create very large variances in lifetime expected credit loss estimates as evidenced by the PCI accounting seen over the last few years. Wide variances in estimates occur quarter-over-quarter and total combined non-accretable and allowance levels have moved materially in a gradually improving economic environment.

Entering into an economic downturn (as perhaps anticipated in a stress test) will require banks to post heretofore unseen amounts of expected credit loss allowance even before the severity of the downturn is known. While safety and soundness is always critical, allowance levels will take the place of capital with no benefit to the financial system. Many more banks may fail under this methodology even when economic downturns turn out to be shallow, and the cost of credit to the consumer could rise to unacceptable levels, resulting in unintended systemic risk.

The lack of reliable data for periods far into the future that are needed to estimate life-of-loan credit losses could result in frequent changes to the estimate of expected credit losses, thus, leading to significant unwarranted earnings volatility. After a foreseeable forecast, economic variables will undoubtedly revert to mean. The mean economic scenario assumption may differ from quarter to quarter for each filer, and mean economic scenarios will certainly differ from filer to filer, further contributing to financial statement non-comparability.

Lastly, discussions with some financial institutions indicate implementation assumptions that will apply a weighting to historical averages or tail risk events to avoid implied volatility inherent in the Proposal. This would essentially require ignoring current economic conditions, in which case, prepayment risk and discounting would also be ignored. We do not believe that was the intent of the Proposal but highlights the subjectivity in implementation.

IV. The Proposal – principles based, will increase the use of judgment by management and thus may ultimately compromise comparability and consistency.

Due to the need for more assumptions than are currently required by the incurred loss model, increased flexibility in application and wide interpretation, comparability and usability by the investor community would be impaired. Increasing the required disclosures does not solve this problem. Disclosures are already substantial. Requiring additional disclosure and documentation from banks will not improve a fundamental understanding of credit risk, credit quality and/or related trending.

Given the wide range of interpretation and judgment required, we believe that users of financial statements will be hard-pressed to compare peer banks or understand the credit quality and trends of credit risk necessary to fairly understand a financial institution.

Below are samples of the range of judgmental estimates that will be required. We do not believe that additional disclosure will bring readers closer to being able to compare or understand the condition of a financial institution's loan portfolio. We believe that current disclosure practices are reasonable, robust and thorough. In this case, we do not believe that more is better.

- Lifetime – How is this defined? What assumptions are used to calculate?



- Modeling approach – Simplistic, historical average (roll rate, loss rate); to what extent are forecasted variables used - sophisticated or complex, explicitly or “implicitly” considers time value of money.
- Weighting – How was weighting of results applied to achieve the number shown?
- Calculation – What are the multiple calculation assumptions incorporated to achieve the estimated result?
- Prepayments and discounting – To what level did these influence results?
- Economic forecasts – How are economic forecasts generated and to what extent do economic forecasts affect the expected credit losses?
- Variance from prior quarter – How did economic variables influence the change in results quarter over quarter, if applicable? How did the change in portfolio influence the change in results quarter over quarter?

From an auditability standpoint, the increased level of subjectivity inherent in the expected credit loss model, as acknowledged by the Board, along with the aforementioned challenges of obtaining reliable data for periods that are far into the future, will likely result in challenges to auditors of financial statements aiming to substantiate management’s estimate with supportable and verifiable documentation. Furthermore, the challenges associated with entity-specific projections of the forecasted direction of the economy would also be subject to prudential regulatory criticism, and the projections will be influenced by regulatory views.

Implementation guidance and examples fall significantly short for most banks in how the lifetime loss rates are calculated, how economic variables are incorporated, the level and depth of the historic data anticipated and required, the modeling approach used, etc.

- V. The amount of effort and cost to comply with the Proposal has been substantially underestimated and in certain cases, such as in community banking organizations, the changes may be challenging at best and impractical at worst. Additionally, several concepts provided in the Proposal are inherently flawed.

Material operational challenges exist with estimating lifetime losses on long-tenured assets (for example, 30-year fixed residential real estate loans) or evergreen assets (for example, home equity line of credit or credit card loans) due to the need for elongated views. We believe that the Board should include illustrative examples of how an entity should go about determining the expected maturity with respect to revolving credit facilities and loans and lending commitments with annual renewal contractual provisions, while allowing banks to continue to take a principles-based approach to determining expected maturity.

We appreciate the consideration and flexibility in the Proposal to allow for current credit loss estimation methods including “loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors.” Allowing for the continued use of current credit estimation methods would (i) create a desirable link between current credit risk management practices and financial statements and (ii) greatly simplify the transition from the current incurred loss accounting model to the future expected loss accounting model.

Unfortunately, many of these methods are unable to estimate lifetime losses and would not pass internal model validation requirements or regulatory muster. Roll-rate and loss-rate models in particular lack an



ability to forecast lifetime loss estimates and most do not incorporate econometric indicators to reflect current and forecasted economic conditions.

Additionally, current credit loss modeling assumptions focus on principal loss and ignore time value of money assumptions. In order to comply with this Proposal, financial statement preparers will be forced to develop new credit loss estimation methods that explicitly reflect the time value of money. These models are operationally complex and would create significant burden on smaller banks to achieve. Larger banks with this functionality indicate that it takes a week to run the suite of models designed to accommodate this requirement.

In order to accurately estimate losses including time value of money assumptions, the preparer must incorporate forecasted long-range economic variables. While undiscounted principal loss is unchanged with economic variables, the timing of a borrower default will materially change estimated expected credit loss. Those financial institutions hoping to avoid volatility will attempt to ignore this factor.

Significant data and resources will be required to attempt to develop lifetime models on closed-end portfolio segments. It will take several years to implement this exposure draft with limited expectation of back testing and no hope of meaningful usage.

Not only would initial implementation costs be high, but maintaining ongoing controls and disclosures around the vast new elements of judgment required by the Proposal would require significant new permanent resources on the part of the financial statement preparers and independent auditors.

VI. Other considerations in the Proposal are also discussed.

- Removing the asymmetrical accounting impact of the purchased credit impaired (PCI) impairment methodology is universally applauded. Current PCI accounting is operationally complex, not well understood and should be converged into normal credit impairment considerations.
- We were disappointed that the FASB did not take the opportunity to reduce the complexity and reporting treatment of troubled debt restructurings (TDRs). We find the accounting treatment and disclosures surrounding TDRs to be overly complex and uninformative from a risk standpoint, and we think that the concept of TDRs should be revamped or dropped.
- We support the codification of a nonaccrual principle but believe it should align to current regulatory standards.

In summary, we very much appreciate the FASB's efforts and hope that our concerns are considered. If there are any questions, feel free to contact James Nelson, director, RMA (215-446-4074 or jnelson@rmahq.org) or Mark Zmiewski, director, RMA (215-446-4085 or mzmiewski@rmahq.org).

Sincerely,

A handwritten signature in black ink that reads 'William F. Githens'. The signature is written in a cursive, flowing style.

William F. Githens
President & CEO