May 31, 2013

Leslie Seidman
Chairman
Financial Accounting Standards Board
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By email: director@fasb.org


Chairman Seidman:

Merrick Bank Corporation ("Merrick" or "we") appreciates the opportunity to comment on the Financial Accounting Standard Board’s ("The Board’s") recent exposure draft ("ED") on the impairment of financial instruments. We also appreciate the considerable effort FASB staff has expended to refine the ED. As will be noted, however, we disagree with the direction the Board is going with this ED.

Merrick is an FDIC-insured state-chartered bank with assets of a little over $1.5 billion. Our primary business is issuing credit card accounts to consumers with checkered credit histories. We also make installment loans in the near-prime market to individuals for the purchase of towable boats, camper trailers and motorcycles. We believe we provide these products in a responsible way, meeting the credit needs of an important segment of the population.

As we will explain more fully below, we urge the Board to revise the ED because:

- We believe the ED ultimately requires a life-of-loan ("LOL") level of reserve, which we believe is inconsistent with the FASB’s Conceptual Framework and basic accrual accounting.
- We believe the ED is very complex. LOL reserves will require a complete re-tooling of lenders’ models and methods of estimating losses. This will place an operational and costly burden on all banks, potentially prohibitive to small ones.
- Long-term projections are unreliable. We find sufficient difficulty as we attempt to reserve for 12 months of losses. Longer periods will bring into financial statements estimates and assumptions with broad margins for error. Financial statements need to be more reliable than that.
• We believe the ED will result in reserves that are more pro-cyclical than less.
• We also believe the ED will result in financial statements that bear little resemblance to economic reality. It will result in book values for loans that aren’t remotely close to fair values and, possibly more importantly, income statement results that distort the economic benefits of holding loans. Income from loan portfolios will be significantly understated in the first year of a loan and overstated in subsequent years.
• We understand that economic factors are not a factor the Board considers in developing accounting standards; however, we believe the ED will have significant negative impacts on banks, lenders and the broader economy. As a result of the ED reserves will increase and capital will decrease. Further, the incremental charge to capital and earnings for all new lending will increase. The net result will be a decrease in lending, and probably a higher cost to borrowers. The effect this could have across thousands of lenders and on hundreds of thousands of borrowers will be significant.

We support various alternatives to the ED. Primarily, we support the Banking Industry Model (“BIM”) advocated by the American Bankers Association (“ABA”). As will be noted, we believe the BIM model accomplishes much of the goals of the ED with only a portion of the complexity and, because it would result in reserves generally less than LOL, it wouldn’t have nearly the impact on the broader economy. Further, we believe the BIM approach is generally closer to the IASB proposal, and may make it easier for convergence to occur at some time in the future. Should the Board adopt the BIM, we also propose that because of the unique nature of consumer revolving credit, and the short-term nature of these loans, that the current expected loss model required by regulators (generally a 12-month loss horizon) be maintained.

A Life of Loan Model is Inconsistent with the Conceptual Framework and Accrual Accounting

From our earliest business classes we were taught that financial statements best reflect the financial condition and results of reporting entities when accrual accounting is used, whereby “the effects of transactions, and other events and circumstances on a reporting entity’s economic resources and claims [are depicted] in periods in which those effects occur.” The LOL model contained in the ED does not follow this principle. The act of making a loan should generally not immediately trigger providing a reserve, especially a LOL reserve.

Lenders originate loans to earn money. That money is only earned over time. The ED would require recognition of a substantial portion of the expenses associated with booking that loan (its lifetime reserve) on day 1, or soon thereafter, while the revenues associated with that loan are only recognized over its life. It could take years for a lender to recognize profit from a pool of loans. Please consider the ED in light of the current treatment of origination costs recognized under ASC -310-20. These costs associated with booking a loan are correctly recognized over the life of the loan. The ED is inconsistent.

1 Concept Statement 8, OB17.
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It appears that a modified incurred loss model (of the type in current practice) is out of favor. Yet that is the best way to match expenses and revenues. A reasonable compromise is either the BIM or a model with a concept of “foreseeable future” that is reasonable, i.e. considerably less than LOL.

**The Model is Complex**

The ED will require completely new models for estimating reserve levels. Certainly for us, the models we’ve used previously would be useless. This will require a significant investment in personnel and technology as new models (unknown at present) are built and tested. This investment will be difficult to make and is a significant burden. By itself this objection may not be reason for the ED to be reconsidered, but considered alongside our other concerns we respectfully ask the Board to reconsider.

**Long-term Projections are Unreliable**

Estimates and assumptions have been and always will be a part of financial statements. That can’t be avoided, but financial statements, in order to be useful, must utilize reliable estimates strongly supported and firmly grounded. Our own experience is that projecting a 12-month reserve is challenging, but it is one with which we have 15 years of experience and one that is, we believe, sufficiently reliable. The ED, however, requires estimates across periods potentially much longer. Even for revolving credit those periods could be longer than 12 months.

The average life of a receivable in our revolving loan portfolio is about 12 months, but according to the ED we might have to reserve for longer periods. These longer estimates obviously become increasingly difficulty. Our installment loans have average lives of about four years and amortization periods generally of 10 years. Analyses of lifetime losses in this portfolio are incredibly volatile.

We believe the ED reduces the quality of financial reporting. Financial statements need to be based on reliable information, and we think the ED introduces long-term estimates that are only marginally better than guesses.

**The ED Will Result in More Volatility**

The long-term loss expectations within a LOL model will add to volatility in times of economic stress. As long-term expectations change, any increase (or decrease) in loss expectations would have a compounded impact (as it is multiplied through longer time periods), increasing the pro-cyclical nature of the lending industry.

In addition, comparability between banks will likely become more difficult. For instance, when a recession occurs, different banks may use different economists’ estimates of the duration of the recession or recovery and come to very different conclusions. The result will be very different loss provisions on what could be similar, from a credit quality standpoint, portfolios.
Financial Statements and Economic Reality

We believe financial statements should reflect economic reality as much as possible. By “economic reality” we mean reasonable values based on the business model of the entity and profits or losses based on recording revenues and expenses in the periods in which they are incurred. While we do not support marking most assets to fair value, we do, however, believe that balance sheets should bear some resemblance to the true value of assets, and under current guidance we believe this is generally accomplished. Similarly, we believe income statements reported in accordance with GAAP should attempt to reflect the true profitability of an entity.

We believe the ED moves balance sheet and income statement reporting away from reality. Larger reserves will result in loan portfolios being presented at greater discounts to face amount, whereas, generally, loan portfolios sell at premiums.

Further, income statement presentation of the earnings from loan portfolios will be reduced for the additional reserves that must be provided under the ED. For our revolving credit loans, specifically, greater reserves could turn a strongly cash-flow positive portfolio (and one that is profitable according to current guidance) into one that is seemingly only marginally profitable. Investors, lenders and other users of our financial reports could draw incorrect conclusions regarding our business. We believe this is going the wrong direction. Concept Statement 8 states that, “The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors.” We believe the approach in the ED does not provide meaningful information to this user group.

We believe GAAP financial reporting should be the best source of financial information (not, of course, to the exclusion of all others). The ED risks degrading the quality and usefulness of financial reporting done in accordance with GAAP.

The Impact of the ED on Lenders and the Economy

We understand that, in accordance with its Conceptual Framework, economic consequences are not a factor the Board considers in developing accounting standards. However, we ask the Board to consider these factors, and the other objections we raise in this letter, against any perceived incremental improvement in financial reporting brought about by the proposed standards, given the significant changes that are being considered.

A stated goal of the ED is to increase reserves. We believe in sufficient, even abundant reserves, however, we believe the ED goes too far and we believe its effect could be damaging to banks, other lenders and the general economy. Excess reserves are as wrong as insufficient reserves.

From conversations in which we’ve participated with other banks we have heard other banks speak of increases in their reserves of 50% to 100%. Our own very preliminary analysis indicates an increase of

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2 Concept Statement 8, OB2.
30% is possible for our revolving credit and 50% for installment. These indications mean that at implementation banks will collectively erase billions of dollars of capital. It also means that subsequent incremental loan growth will be more costly. One certain result of the ED will be a decrease in lending.

This collective decrease in lending will have broad repercussions across the economy. We believe that this likely outcome is, in and of itself, reason enough to ask you to consider an alternative to the ED.

Conclusion

We respectfully request that the Board reconsider the ED. For the reasons stated above we believe the ED goes too far, is inconsistent with basic accrual accounting and is potentially damaging to the economy.

Further, The ED is trying to accomplish a goal that is inconsistent with its own Concepts, in that it seeks to increase the durability of lenders to economic downturns – rather than to report their financial condition. The Board decided in Concept Statement 8 that the purposes of financial reporting are not primarily to maintain financial stability. Maintaining financial stability is the job of management and regulators through proper risk management practices and adequate capital maintenance; it is not the job of accounting guidance.

Our first choice is that the Board pursues a course that seeks to flesh out principles outlined in the BIM. We believe this approach maintains consistency with basic accrual accounting, is more faithful to the basic tenets of FASB’s Conceptual Framework regarding recording transactions in the period in which they occur, and best satisfies the objective of providing the most relevant information for decision making to investors and lenders. We believe, because it is closer in principle to current practice, it can be implemented for only a fraction of the cost and disruption of the ED. The BIM is also an evolutionary change to practice that has been in place, and generally served well, for many years. Further, it is modestly closer to the IASB approach, holding out the potential for some convergence in this area at some date in the future.

We also respectfully request that the Board consider specific guidance relative to consumer revolving credit, whether the Board adopts something similar to the BIM or the ED. The requirements of the ED would be particularly onerous for consumer revolving credit loans. With respect to consumer revolving credit LOL reserving requires multiple layers of assumptions regarding the cash flows applicable to the receivables of this balance sheet date, versus those of a subsequent date, and of course charge-off assumptions necessarily follow. This layering of assumptions could result in considerable differences of opinion between us, our auditors and regulators. We propose that the Board specifically adopt the approach that has been the practice for many years – a reserve designed to cover 12 months of losses. This is what virtually all issuers of revolving consumer credit are doing now, it is relatively simple to administer and fully adequate.

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3 Concept Statement 8, BC1.23
If the Board chooses to remain on its current course, we ask that before implementation you perform an analysis of the impact of the ED on lenders and the general economy. A change of this magnitude must be understood before it is implemented. Our own preliminary analysis indicates that should the ED be implemented we will be forced to reduce lending before and after implementation. Preliminary indications from other banks with whom we’ve spoken are similar. If that is multiplied across the thousands of lenders in the nation the effect will be significant on the economy.

We do not disagree with the ED simply because we believe lower reserves are better. On the contrary, in 2003 we commented to the AICPA on a Proposed Statement of Position on Allowance for Credit Losses (issued June, 2003). The direction of that proposal was to emphasize the incurred loss model and, generally, to lower reserves. We disagreed, asking the AICPA to reconsider. Similarly, we urge the Board to reconsider this ED.

We have not included our responses to the questions you pose in the ED as we believe those are adequately answered in the letter you have received from the ABA.

Again, we appreciate the opportunity to comment on this ED. Thank you for considering our opinion. If you would like to discuss this letter please contact me at 801-545-6602 or dave.young@merrickbank.com. I would be happy to discuss its contents with you.

Respectfully submitted,

[Signature]

David Young
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Merrick Bank Corporation