American Bankers Association
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The Honorable Thomas Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, DC 20219

The Honorable Janet L. Yellen
Chair
Federal Reserve Board, Eccles Board Building
20th and C Streets, NW
Washington, DC 20219

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Dear Comptroller Curry, Chairman Gruenberg, and Chair Yellen:

The Financial Accounting Standards Board (FASB) first proposed its Current Expected Credit Loss (CECL) model for credit loss accounting in 2012, and the federal banking agencies have been steadfast in their support of CECL from that time until now. When issued, CECL will not only represent the biggest change in bank accounting over the past forty years, it may change the way many financial institutions operate – from granting and managing credit to budgeting and capital management. CECL's "life of loan" loss estimation process will result in significant time and resources to implement. Therefore, it is critical that final agency support for CECL be given only with costs and benefits being fully understood. While FASB's due process includes a cost-benefit analysis prior to issuance of any FASB standard, we respectfully request that the agencies take an active and detailed role in the FASB's process to ensure that an in-depth cost-benefit analysis is performed and the results are communicated to and understood by the banking community.

It is imperative that the cost-benefit analysis contemplate not only what satisfies minimum requirements in performing a CECL estimate, but what will most likely be used in real life. While a principles-based CECL standard will not explicitly require specific methodologies, we believe addressing many common credit risk questions on an ongoing basis under CECL will necessitate significant upfront and ongoing investment by banks of all sizes in manpower, systems development, and maintenance.

In addition to the cost and benefit issues FASB needs to address, we believe it is important that the agencies evaluate the new standard's practical impact on bank capital. To further respond to the pronounced measurement uncertainty of a long-term forecast of future losses, banks may need to maintain larger buffers when managing capital. Adding to the buffers maintained today that address typical model risk, such buffers could significantly reduce the amount of capital a bank may deploy into its local community.

Attached is our letter sent to Russell Golden, FASB Chairman, on issues the cost-benefit analysis must address. The key issues from that letter are summarized below.

New Databases Will Need to be Developed and Managed

While complying with *minimum* CECL requirements could limit the amount of data needed, a realistic CECL implementation – one that will provide light on reasonable questions that both auditors and bank directors will ask on an ongoing basis – will likely require databases many times the size of those currently maintained by most banks. We believe that most banks will seriously consider a vendor solution to perform such ongoing duties and that certain relevant data at many banks will be unavailable to perform CECL estimates for several years. Other procedures, analyses, and provisions will be required to make up for this.

Quantifying Forecasts of the Future Will Require More Sophistication

Life-of-loan credit loss forecasts add complexity because, over time, loans react differently to individual economic forecasts, based on credit quality, individual loan terms, age and scheduled maturity. Quantifying the most basic adjustments to historical loss experience in order to arrive at final loss expectations under CECL will involve levels of complexity that have never been faced by most banks. At a minimum, much more granular analyses will likely be expected or required,[1] and certain auditor and regulatory publications have already suggested that correlation analysis will help link forecasts of key economic drivers (such interest rate increases) to credit loss estimates for various types of loans.

A small number of banks may be able to perform such analyses using their existing spreadsheets. However, it is likely that most banks will seriously consider utilizing relatively complex analytical and modeling software solutions in performing their CECL estimates.

Different Credit Metrics Will Be Needed

Reported charge-offs, delinquencies, and other widely-used credit metrics will have less relevance to CECL-based loan loss allowances, since expected losses are effectively recorded at origination. The change from current accounting to CECL may also reduce the reliance on peer analysis that exists today related to industry charge-off ratios. The industry will need to respond to this not only through in-depth and ongoing education among management, board members, examiners, and investors, but also by embedding wholly new metrics into the internal controls of this reporting process.

Auditing Procedures Will Likely Change

Small changes to CECL-based loss assumptions can cause very large changes to profit and loss, and will be accompanied by the measurement uncertainty of a long-term forecast of expected credit losses.[2] This will increase the cost of the audits and the level of supporting documentation

[1] Per the Federal Reserve Board's February 2016 *Community Banking Connections*, "Loan portfolios… should be accounted for at the most granular level possible, as more granular segmentation allows for better loss estimates."

[2] International Auditing and Assurance Standards Board ***An Update on the Project and Initial Thinking on the Auditing Challenges Arising From the Adoption of Expected Credit Loss Models***: "Given the complexity and uncertainty implicit in an ECL (expected credit loss) model, and the significant level of judgment involved in

a bank will be required to produce in order to support its assumptions. In many cases, auditing firms may need to employ modeling professionals in order to evaluate the reasonableness of the quantitative effect that specific assumptions of the future have on the loss expectation. Bank examination staff will likely need these professionals, too. This may even be mandatory if banks use advanced models.

Incremental Benefits Compared to Current Practice May Be Limited

While the incurred loss model for credit losses has been criticized for not capturing sufficient "forward looking" information, actual practice in the United States often reflects significant forward-looking aspects. For example, subsequent to the depth of the financial crisis, in agreement with regulators and auditors, banks with large exposures to certain home equity lines of credit started providing for credit losses well in advance of individual borrowers becoming delinquent, because of the view that losses had been incurred but not yet identified on an individual loan level. Conventional criticism of the incurred loss model really does not address today's generally accepted incurred loss accounting practice.

With all this in mind, the agencies need to analyze the impact that CECL may have on capital buffers and assist FASB in determining whether the anticipated costs noted above are outweighed by the incremental benefits of a CECL accounting standard. Because of the anticipated impact CECL will have on how banks grant credit and deploy capital, the industry deserves a robust and open cost-benefits process. Detailed explanations of the cost expectations on banks and how the industry and its users will benefit from CECL are truly needed. Only then will banks be able to efficiently make the right investment decisions to implement CECL in the most cost-effective way possible to prepare for the effective date.

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; 202-663-4986) or if you would like to discuss our views.

Sincerely,

Donna J. Fisher

Donna J. Fisher

cc: The Honorable Mary Jo White, Chair, Securities and Exchange Commission
Mr. Russell G. Golden, Chairman, Financial Accounting Standards Board

Attachment

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measuring the ECL, it is possible that the auditor's range, or the difference between management's estimate and the auditor's point estimate, may be *multiples* (emphasis added) of performance materiality." Such complexity and uncertainty will undoubtedly affect audit costs and capital buffers.

Key Cost-Benefit Analysis Issues

The following are, at a minimum, the issues that the cost-benefit analysis should address. Although CECL might not, on its surface, *require* some of the processes described below, we believe investors, regulators, auditors – and even bankers – may believe the additional processes are necessary for proper implementation under CECL. It is the anticipated processes that must be evaluated in the cost-benefit analysis.

New Databases Will Need to Be Developed and Managed

As historic experience is expected to be the starting point for CECL estimates, many banks of various sizes will likely need to build and manage extensive databases of life-of-loan credit-risk data not previously retained. CECL necessitates life-of-loan data, which is significantly different and more voluminous from the annual charge-off data in use today, entailing different data points across the life of each loan and requiring additional complex calculations to arrive at loss rates. Much of the needed data has been generated through disparate, unlinked systems and are either currently purged or maintained in formats that are not audit-ready. Some of the required data may not be available in sufficient quantity or quality to use as a basis for CECL estimates by the proposed effective date.

While complying with minimum CECL requirements could limit the amount of data collected, a realistic CECL implementation – one that will address reasonable questions that both auditors and bank directors will ask on an ongoing basis – will likely require databases many times the size of those currently maintained by most banks. For example, life-of-loan-based loss rates disaggregated by credit rating or delinquency status require multiple data markers to be maintained on each loan during each period a loan is outstanding.[3]

Incremental costs that bankers will incur include acquiring, "scrubbing" (ensuring accuracy), and linking historical data from core system providers, as well as collecting, maintaining and managing the data and the related internal controls on an ongoing basis.[4] We anticipate that many banks may need to consider a vendor solution to perform such ongoing duties.

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[3] Very little industry discussion has been conducted related to the specific best methods in estimating life-of-loan credit losses across products. However, initial discussions related to estimating credit losses on revolving credit lines have focused on forecasting cash flows. Unless shortcuts can be agreed upon, data supporting cash flow forecasts will likely require virtually every transaction to be maintained on such loans in order to provide relevant historical data.

[4] Certain ABA community bank members have received estimates from their core system providers that are material to those banks. We believe that per-bank costs could be significantly reduced if a common set of data needs were developed for the service provider's client base. There has been discussion about whether the federal banking regulators should define the common set of data needs; however, the proprietary nature of certain credit-risk-related data could significantly reduce the agencies' capability to define and/or require such data. As a result, FASB's cost-benefit analysis should not assume such costs can be reduced.

Sample questions to be answered:

- What are the costs of developing the database and maintaining it for ongoing implementation of CECL?
- What additional costs are needed to ensure that internal controls over the initial and ongoing processes are in place and are reviewed by management and external auditors?
- How many years of historical data will provide reasonable basis for life-of-loan loss expectations?

Quantifying Forecasts of the Future Will Require More Sophistication

Life-of-loan credit loss forecasts add complexity because, over time, loans react differently to individual economic forecasts, based on credit quality, individual loan terms, age and scheduled maturity. While the difference between CECL and current practice may not initially appear significant for shorter tenored loans, it greatly magnifies for longer tenored loans. For example, many currently assume that the Federal Reserve will increase interest rates over a period of time. Such an assumption creates several new considerations under CECL:

- Future interest rate increases will affect variable-rate loans differently from fixed-rate loans.
- Forecasts of losses on those variable-rate loans will differ for those that mature within the next year compared to those that will be outstanding for the next two to three years.
- Borrowers with lower credit ratings may react, over time, to such interest rate changes differently from those with higher credit ratings.
- As loss experience related to specific portfolio *vintage* years may have more relevance to future credit loss expectations than loss experience related to portfolio *fiscal* years, bankers and auditors may often need to question *which* historical loss experience provides the best starting point for CECL estimates.

Considering that interest rate movement is only one of several economic factors included in a forecast of the future, quantifying the most basic adjustments to historical loss experience in order to arrive at final loss expectations under CECL will likely involve levels of complexity that have never been faced by most banks. Much more granular analyses will likely be required.[5] Historical data is not likely to be stagnant; that is, it will likely need to be continuously evaluated alongside periodic changes in the environment. Certain auditors and regulators also have recommended correlation analyses to help link forecasts of key economic factors (such interest rate increases) to future credit loss estimates for the various types of loans.

Some are assuming that less sophisticated institutions will be under less pressure from auditors and examiners (compared to more sophisticated institutions) to provide specific quantitative support for adjustments made to historical experience. For banks that perform allowance analyses on spreadsheets today, they may likely need to consider utilizing third-party analytical

[5] Per Federal Reserve Board's February 2016 *Community Banking Connections*, "Loan portfolios… should be accounted for at the most granular level possible, as more granular segmentation allows for better loss estimates."

and modeling software solutions in performing their CECL estimate for several compelling reasons:

- The software solution will likely enable a more controlled transfer and update of the additional detailed data required for the CECL calculations.
- Small changes in assumptions used to make long-range loss estimates can result in potentially significant changes to net income and capital, and bankers will want to better understand the impact of the assumptions used. This will also be a critical part of the annual audit and regulatory examination.
- More sophisticated models may allow bankers to easily change assumptions and methods as general practice in the industry and their understanding of the data evolve.

Sample questions to be answered:

- What additional data, processes, and documentation will be needed to forecast future losses?
- How many institutions will likely purchase software to perform CECL estimates, whether to meet the needs of CECL or to better manage the process?
- What are the costs being estimated by service providers, both at implementation and ongoing?

Different Credit Metrics Will Be Needed

Reported charge-offs, delinquencies, and other widely used credit metrics will have less relevance to CECL-based loan loss allowances, since expected losses are effectively recorded at origination. The change from current accounting to CECL may also reduce the reliance on peer analysis that exists today related to industry charge-off ratios. The industry will need to respond to this with:

- Education: Significant education among management, bank board members, bank examiners, and investors will be required to help sustain confidence in bank financial statements.
- Internal Controls: An effective internal control system is an important component for bank investors' confidence in reported results and management. To the extent that traditional credit metrics and measures are used in management review control procedures, those metrics and measures must be re-evaluated under the CECL framework to determine whether they continue to provide effective information to management in evaluating credit loss provisions and allowances. Probabilities of default, losses given default, expected delinquencies, and expected loan-to-value statistics – all potentially requiring significantly more detailed data than now maintained – may be considered as appropriate metrics.

Sample questions to be answered:

- What analytical tools will bankers use in analyzing life-of-loan loss provisions? How will such processes be integrated into operational and credit review processes?
- What general metrics and tools are investors likely to use?
- How will bankers and investors compare pre-CECL years to post-CECL years?

Auditing Procedures Will Likely Change

At a minimum, additional audit procedures will likely need to:

- Test the reliability of the additional data underlying the CECL-based life-of-loan loss estimate, and
- Evaluate the more granular assumptions made of future conditions, based on a more granular analysis of loan products, terms, underwriting procedures, and when the loans were issued.

In many cases, auditing firms may need to employ modeling professionals in order to evaluate the reasonableness of the quantitative effect that specific assumptions of the future have on the loss expectation. Bank examination staff will likely need these professionals, too. This may even be mandatory if banks use advanced models.

Small changes to CECL-based loss assumptions can cause very large changes to profit and loss. This, along with the measurement uncertainty of CECL's long-term forecast of expected credit losses, is not lost on the auditing profession. The International Auditing and Assurance Standards Board paper ***An Update on the Project and Initial Thinking on the Auditing Challenges Arising from the Adoption of Expected Credit Loss Models*** notes that auditing expected credit losses (ECL) remains a significant challenge still to be resolved:

"Given the complexity and uncertainty implicit in an ECL (expected credit loss) model, and the significant level of judgment involved in measuring the ECL, it is possible that the auditor's range, or the difference between management's estimate and the auditor's point estimate, may be multiples (emphasis added) of performance materiality…For financial institutions, such large ranges can result from only minor differences in assumptions due to the size of the exposures and the sensitivity of the output to changes in the assumptions. It is possible that well-credentialed and experienced experts may disagree with respect to the appropriate assumptions for a given circumstance."

Such complexity and uncertainty will undoubtedly affect audit procedures and costs. However, until the general extent of additional detail needed is known for auditing purposes, informed resource allocation decisions at many banks cannot be made. In other words, many bankers will not know what data to collect unless they are confident about what will satisfy the auditors.

Sample questions to be answered:

- Have external auditors identified the costs of any systems and personnel changes that they plan to pass on to their bank clients? Are there ways that audit and examination costs can be mitigated or reduced on an ongoing basis?
- Do external auditors generally agree upon how increased measurement uncertainty will be addressed during individual audits? Will this affect the nature of supporting documentation a bank will be required to provide during an audit?

Incremental Benefits Compared to Current Practice May Be Limited

While the incurred loss model for credit losses has been criticized for not capturing sufficient "forward looking" information, actual practice in the U.S. often reflects significant forward-looking aspects. For example, subsequent to the depth of the financial crisis, in agreement with regulators and auditors, banks with exposures to certain home equity lines of credit started providing for credit losses well in advance of individual borrowers becoming delinquent, because of the view that losses had been incurred but not yet identified on an individual loan level. Therefore, when considering the costs versus benefits of a "life-of-loan loss" accounting model, CECL should be compared to the actual practices in existence today.

We acknowledge that, even today, the allowance for loan and lease losses is an estimate requiring judgment and, therefore, differences exist in both loss estimates and the assumed loss emergence periods banks often use in those estimates. Although CECL will eliminate the differences regarding estimated loss emergence periods, the range of reasonable loss estimates are likely to widen considerably because of the long-term forecast (based on management's assumptions) that is integral to the CECL model. Given this, CECL may not increase comparability among banks, but may likely reduce it. For these reasons, as well as the increased measurement uncertainty inherent in CECL, many bankers question whether CECL represents a substantial improvement when compared with today's practice.

Sample questions to be answered:

- What additional regulatory and supervisory action will be required to address the additional measurement uncertainty that CECL presents? Will the agencies need to revise capital requirements? How much additional guidance is needed to provide consistency of economic forecasts and the application of those forecasts to specific types of loans and/or loan portfolios?
- Will peer analysis be an important part of the supervisory process in the future? If so, will additional disclosures be required that would add to the costs of CECL?
- What incremental benefit does CECL provide over current accounting practice?