American Bankers Association
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Michael L. Gullette
Vice President – Accounting and Financial Management
202-663-4986
mgullette@aba.com

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Basel Committee on Banking Supervision
Bank for International Settlements

Via website submission: http://www.bis.org/bcbs/commentupload.htm

Re: Consultative Document: *Prudential Treatment of Problem Assets – Definitions of Non-performing Exposures and Forbearance*

To Whom It May Concern:

The American Bankers Association (ABA[1]) appreciates the opportunity to comment on the Consultative Document *Prudential Treatment of Problem Assets – Definitions of Non-performing Exposures and Forbearance* (CD). The CD, if finalized, will not only provide common definitions for banks in many countries in reporting the status of problem loans, it may also become a reference point for Basel Committee decisions affecting capital or otherwise may be used as a data point for accounting or financial reporting. Therefore, the potential implications of a final CD are wide and deep, and we believe that consideration of any comments received on the CD be thoroughly vetted with those potential implications in mind.

Banking institutions in the U.S. have had longstanding definitions of nonaccrual (which closely aligns with non-performing) and troubled debt restructurings (forborne exposures), and we are concerned that significant unintentional consequences may lurk behind the CD's new definitions. ABA believes that reported amounts of non-performing and forborne exposures and the changes in those amounts will often have little relationship to the level of credit risk within individual entities or within the industry as a whole. With this in mind, we have listed several recommendations.

<u>The definitions should align with accounting and reporting standards</u>

The purpose of the CD is to achieve greater comparability of credit categorization among banks and jurisdictions by developing common definitions for of the terms "non-performing exposures" and "forbearance". While we understand that the Basel Committee did not intend to develop definitions that are related to terms used for financial reporting purposes (nor did it intend that the definitions would result in accounting change), the terms "non-performing" and "forbearance" are, nonetheless, very closely associated to the terms currently used in U.S. accounting for "nonaccrual" and "troubled debt restructuring", respectively. As a result, significant and unnecessary confusion among management, regulators and investors will result when similar, yet not identical, terms are used.

[1] The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans..

Even though it is not the Basel Committee's intent to link the new definitions to accounting, the usage of such terms in the U.S. may have implications to investors, as the definitions may be used for, among other things, analyzing the reasonableness of allowances for loan losses. After all, the terms used for accounting and financial reporting purposes are meant to reflect economic reality.

Due to the years of experience in application of the current accounting definitions of nonaccrual and troubled debt restructuring in the U.S., ABA recommends that the proposed definitions of non-performing and forbearance adhere as closely as possible to U.S. usage. Any change in definition will merely introduce confusion among both investors and bankers without improving risk measurement.

The CD should recognize that collateral and other security are vital to loan quality

Within the CD, collateralization plays no role in the categorization of non-performing exposures. However, collateral is currently an important consideration related to both nonaccrual loan status and nonaccrual loan accounting in the U.S. under the following circumstances:

1. Loans that are over 90 days past due are not considered nonaccrual loans when well secured and in process of collection.[2]

   It is common for banks to hold loans and securities (collateralized by loans) that are guaranteed by the U.S. government (or government sponsored enterprise), including some residential mortgages, commercial loans, and student loans. Excluding the consideration of collateral in these widely-held asset classes will significantly overstate the risk held by the bank.

2. Loans are commonly underwritten with the expectation that repayment is based on the liquidation of collateral in the ordinary course of business[3].

   Certain types of routine loans (real estate construction, inventory and receivables, and certain energy production) would be reported under the CD as non-performing upon origination, even though they are performing in accordance with liquidation expectations. Such classification would not correspond to the level of credit risk that the Basel Committee is intending to identify.

3. Interest income recognition is often based on the adequacy of collateral.

   Nonaccrual loans that are adequately collateralized may apply a cash basis method of income recognition (instead of a cost recovery method for those loans without adequate collateral). While such loans would be reported as non-performing as defined in the CD,

[2] Per the U.S. call report instructions, an asset is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt(including accrued interest) in full, or (2) by the guarantee of a financially responsible party.
[3] Paragraph 24(iii)(b)

cash basis method recognition effectively creates a subclass of nonaccrual loans by acknowledging a dollar value of credit risk that is far less than for loans not adequately collateralized.[4]

In each circumstance, the treatment of the loan, from a perspective of the practical credit risk that both investors and regulators wish to assess, would be inappropriately categorized if the collateral were not considered.

Unintended consequences would often result by defining non-performing loans without regard to the adequacy of collateral. On the one hand, the number and amount of reported non-performing loans would reflect inappropriately higher credit risk. On the other hand, the overall level of allowance for loan and lease losses (ALLL) could decrease if the new definitions are used for accounting purposes. Under current U.S. GAAP, the ALLL for unimpaired loans (a pool-based allowance based on ASC 450-20) is often higher than what is calculated through the individual loan impairment measurement (under ASC 310-30) that considers collateral value. We believe neither of these results is the intent of the Basel Committee.

<u>The CD should strive to achieve alignment and consistency in consideration of exposures</u>

The CD requires that assumption that all exposures are considered to be non-performing if any one exposure of a borrower qualifies as non-performing. We believe this will result in inconsistencies that can often result in an unintended distortion of the level of credit risk:

1. For borrowers that are served with multiple credit facilities, the CD proposes that facilities with individual guarantees to different legal entities, as well as other facilities with specific collateral arrangements or other securities, are all considered non-performing if one facility is non-performing. This appears to contradict how bankers normally assess risk, as many of these facilities are separately underwritten at different times in light of collateral obtained.

   We understand the importance of detailed evaluation of all exposures when individual facilities are at risk (for example, determining whether personal guarantees initially provided by the borrower are still sufficient). However, we see no reason why a metric that is publicly reported (in this case, non-performing loans) would be based on the assumption that all facilities are non-performing, especially if a specific exposure in question is well secured. For example, current practice in the U.S. related to “A/B” restructurings normally allow partial write-off and reclassification to performing status (after sufficient repayment performance). We are not aware of any problems with this practice and we believe such practice should continue, as it appropriately categorizes the risk evaluated in a methodical fashion. The proposed definition also appears to provide a disincentive in providing such restructuring alternatives, resulting in the unintended

[4] Cash basis income recognition largely results from the U.S. practice of measuring impairment for impaired collateral dependent loans by the difference between the asset’s carrying value and the fair value of the collateral (less estimated sales costs).

consequence of a reduction in institutions offering creative workout solutions such as these.

2. In contrast to individual borrowers served with several facilities, many debt securities in the U.S. are single instruments that may contain exposure to hundreds of separate borrowers. The structure of many of these securities often contains individual loans that could be considered non-performing, though the cash flows of the security held by the investor are not affected. An AAA-rated tranche of an asset-backed security is an example. On the other hand, other securities may have adequate current cash flows, though they should qualify as non-performing because of foreseeable deficiencies based on the structure.

Based on the proposed definition of "non-performing", we also believe the extent of credit risk throughout the industry can be significantly distorted, as different institutions holding different shares of the same such securities would be similarly reported with the same distortions.

<u>The strict criteria may distort overall credit quality that is maintained by otherwise prudent practices</u>

The definition of non-performing exposure (paragraph 24) needs to take into account prudent practices that may make the non-performing status either irrelevant or misleading.

1. Non-accrual (non-performing) classification is not applied in the U.S. to credit cards, as the accounts are charged off at 180 days. Due to relatively quick loan modification/repayment programs and charge-off period, an arbitrary 90 day past due definition does not adequately account for meaningful work-out processes by the bank. The reported number will then lose relevance by the next reporting period, as many of these exposures are written-off.

2. Loans and debt securities purchased with credit impairment (PCI) are normally acquired with significant discounts and also are often accounted for in pools as the units of account. PCI assets accounted for in pools, many of which may otherwise individually be considered non-performing under the CD, are currently not included as nonaccrual loans in U.S. call reports. Due to the significant purchase discounts, non-performing PCI assets have, as a whole, performed significantly better than their initial discount implies. Troubled debt restructurings offered to these borrowers then often significantly improve the cash flow prospects over those initially priced into the loan. Therefore, a non-performing or forbearance status related to these assets would greatly distort the economic risk of the bank.

3. Relative to the measurement of the uncancellable nominal amount of a loan commitment (paragraph 23), no consideration is made in the CD for protective clauses included in the note that limit the total exposure, such as Material Adverse Change clauses. If the objective of the definition of "non-performing" is to provide a basis for effective risk analysis, we believe that such clauses should be included when measuring the exposure.

We believe that without considering the prudent practices noted above, the unintended consequences of inappropriately higher credit risk is assumed where, in fact, the credit risk can be lower than other comparable assets.

Recovery Principles Should be based on Experience

In the U.S., requiring 6 months of continuous repayment of a loan subject to a troubled debt restructuring in order to cease the nonaccrual (non-performing) status has been practiced with little problem. We see no reason to arbitrarily extend that guideline to 12 months, as has been proposed in paragraph 41 (i). If a bank can quantitatively prove that the vast majority of loans perform adequately after a 6 month period, we believe it should be able to consider these loans as performing (of course, assuming that the applicable loan is otherwise considered performing).

Overall Clarification

The materiality concept is explicitly referred to in certain sections of the document, though not in others. This indicates that materiality should not be considered for some of the items, which may need clarification.

In summary, ABA understands the Basel Committee's desire to obtain comparable information from institutions in assisting the assessment of credit risk industry-wide. However, the accounting regime in the U.S., which has been in effect for many years and is based on an intent to reflect current credit risk, is largely based on terms that are very close to "non-performing" and "forbearance". This regime also appears to already address the many complexities of credit risk analysis, including consideration of collateral, structured securities, and purchased credit-impaired assets. Unless the Basel Committee finalizes definitions that conform to U.S. practice, we believe many instances will occur in which credit risk, as reflected through reported numbers and amounts resulting from the proposed definitions, will be distorted and lead to more confusion among not only investors, but the supervising regulators who will use the data.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,

Michael L. Gullette