1. **Why is FASB issuing this Exposure Draft (ED)?**

FASB has been working on projects to address various aspects of financial instruments for many years. As part of the most recent effort, an exposure draft was issued in 2010 covering the classification and measurement of financial instruments, impairment, and derivatives and hedge accounting. Since that time, the FASB has split the project into three smaller projects, with the impairment ED released in December 2012 (with comment period ending 4/30/13), the hedging and derivatives ED expected this year, and this classification and measurement (C&M) ED. The FASB’s intent with these C&M proposed changes is to simplify the accounting as much as possible. [TOP]

2. **What does the ED cover?**

At its core, classification and measurement addresses the question “What is marked to market and what isn’t?” The ED, however, does not apply only to financial assets (such as loans and debt securities), but also to financial liabilities. So, the ED provides guidance about how to determine what financial assets and liabilities qualify to be recorded at amortized cost, what should be marked to fair value – with changes in fair value recorded through earnings, and what should be marked to fair value – with changes in fair value recorded through other comprehensive income (OCI).
It should be noted that the financial assets and liabilities addressed in the ED do not only relate to those held by banks, but by any company. Therefore, this ED covers a lot of ground. [TOP]

3. **Is this the sequel to the FASB proposal to require mark to market accounting for loans?**

This IS the sequel to the 2010 FASB ED that required all financial assets and liabilities, including loans and deposits, to be recorded at fair value on the balance sheet. Because of the overwhelming negative response by virtually all FASB constituents (banks and bank investors included), FASB dropped that proposal. [TOP]

4. **What are the key issues in this ED?**

In answering this question, it is important to segregate the accounting aspects of the ED (the debits and credits) from the disclosures (in footnotes as well as on the face of the financial statements). Overall, ABA is concerned about:

- **The accounting** – For banks that hold relatively complex instruments there is the possibility that more instruments may require MTM than are at market today.

- **The disclosures** – The newly-required disclosures for publicly held banks will likely be a challenge. On the face of the balance sheet, fair value must be disclosed for the loan portfolio. (Actually, the disclosure will be for all assets accounted for at amortized cost). Further, in the footnotes to the financial statements, new information related to core deposits will be required.

- **Fair value disclosures** – Banks already disclose the fair values of loans in the footnotes. However, the vast majority use an “entrance price” in estimating fair values, whereas an “exit price” will now be required.1 Because banks generally do not manage based on fair values, and banking analysts have told the ABA that they generally disregard the existing fair value disclosures, we believe costs will go up for the publicly held banks that this requirement applies to for very little informational benefit.

- **Core deposit disclosures** – Publicly-held banks will be required to disclose the balance of what it regards as core deposits, the assumed maturity of these deposits, and the assumed all-in cost to service the deposits. FASB’s proposal intends to allow banking analysts to better forecast funding needs and, correspondingly, net interest income. This core deposit information has never been required previously, except when estimating a “core deposit intangible” during a business combination or sale of branches. This information also has little relevance to the deposit balance in the financial statements, and the

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1 An exemption for “entrance price” has existed since disclosures first became required in FASB Statement 107.
definition of “core deposits” in the ED often does not correlate with how banks define them. ABA is, therefore, skeptical of how much incremental benefit this information will provide to the buy/sell decision of a banking analyst. So, as with the “exit price” fair value disclosures, costs will increase with little benefit received. [TOP]

5. **Will this change my FAS 115 classifications for debt securities?**

In some cases.

FASB has introduced a classification model that is used for all financial assets, including equities, loans and securities – one model. The FAS 115 classifications of “held to maturity”, “available for sale”, and “trading” are replaced by generic names that describe the applicable accounting: “amortized cost” (AC), “fair value, with changes in fair value recorded through other comprehensive income” (FVOCI), and “fair value, with changes in fair value recorded through net income” (FVNI). For the most part, this terminology and the measurement are similar to those you are familiar with under FAS 115 (exceptions are described later in this document), and they will now be applied to loans, too. However, the rules for identifying which instruments belong in which categories are new: it is assumed that all financial assets will be classified as FVNI unless two tests are passed:

1. The cash flow characteristics test (they must be solely of principal and interest)
2. The business model test

If an instrument passes both tests, it will be classified at AC or FVOCI. [TOP]

6. **What is the bottom line -- will more assets be marked to market?**

Most banks will have some instruments that are currently in an AC or FVOCI classification that will move to FVNI, but not many. For an asset to qualify for AC or FVOCI, the cash flows must be composed solely of principal and interest (SPPI). As a result, “vanilla” portfolio loans and securities will stay in AC or FVOCI. Here’s what will have to be recorded in FVNI because of their cash flow characteristics:

A. Equity securities, including both common and preferred stocks.²
B. Hybrid securities (loans that may re-price based on non-interest rate indices or interest rate indices that do not coincide with the going cost of money). Convertible debt, which has both equity and debt features, that is held as an asset³ is an example.⁴

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² Equity securities are discussed in more depth below. Depending on the specific terms, ABA believes that certain trust preferred and perpetual preferred securities may qualify for AC or FVOCI. There is an additional test, however, for specific tranches held (see below).

³ Hybrid security liabilities, such as convertible debt, may be bifurcated so that the host contract is accounted for at amortized cost, with the embedded derivative split out and accounted for as a derivative.

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C. Tranches of structured securities in which either you cannot “see through” to the underlying assets (you don’t know what you’ve actually invested in – for example, you own a tranche of a CDO that owns tranches of CDOs and so on) or the credit quality of the tranche at origination is less than that of the whole security (this would normally be a subordinate or mezzanine tranche).

D. Interest-only and principle-only strips.

E. Derivatives (this proposal does not change derivative accounting).⁵

The trick is determining the meaning of SPPI. Payment of interest can only account for the time value of money (including liquidity risk) and of credit risk. Certain common loan terms, therefore, may not meet the SPPI test. For example, a loan rate that re-prices quarterly based on a one month LIBOR rate may not qualify, because the repricing does not match the market interest rate at the time. The view is that something other than principal and interest is being received.

Another challenge banks will have relates to non-super senior tranches of securities (see C above regarding tranches). The analysis for determining whether the credit risk of the tranche held is sufficiently high is very complex.

Relating to hybrid securities (those loans that do not have SPPI), companies currently often split out the “embedded derivative” (which is marked to market) and account for the “host” instrument separately (which is at AC). This bifurcation process will no longer be allowed and the entire instrument will be recorded as FVNI.⁶

7. Most of my assets are pretty “vanilla”. How will I classify my loans and securities?

Once an instrument has proven to produce cash flows that are solely of principal and interest (in other words, it’s a vanilla instrument), the bank will classify the asset as AC or FVOCI based on the business model for holding the instrument:

- If the business model’s objective is to hold the assets for the collection of contractual cash flows, the asset is classified at AC.

If the business model’s objective is both to hold and to sell the assets (in other words, the bank has not determined whether such assets will be held or sold), then the asset is classified as FVOCI. In its examples, FASB specifically mentions that if a portfolio is maintained for liquidity purposes or is readjusted for asset/liability matching purposes, it would meet the FVOCI business model objective.

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⁴ Convertible debt issued by a company (reported as a liability) will continue to be allowed to be bifurcated between the debt and equity portions and accounted for separately.

⁵ FASB is expected to address hedge accounting for derivatives upon finalization of this standard.

⁶ The embedded derivative “double double” test will no longer be considered. In effect, it is replaced by the SPPI test.
8. **How do the new classifications differ from current GAAP?**

The differences between current GAAP and the proposed classifications can be thought of this way:

<table>
<thead>
<tr>
<th>Current GAAP</th>
<th>Current Accounting</th>
<th>Proposed Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Held to Maturity securities</td>
<td>Amortized Cost</td>
<td></td>
</tr>
<tr>
<td>Loans Held for Investment (for the foreseeable future)</td>
<td>Amortized Cost</td>
<td>Amortized Cost (AC)(^7)</td>
</tr>
<tr>
<td>Purchased Credit-Impaired Loans held for Investment*</td>
<td>Present value of future cash flows</td>
<td></td>
</tr>
<tr>
<td>Available for Sale securities</td>
<td>Fair value, with changes in fair value recorded in OCI</td>
<td>Fair value, with changes in fair value recorded in other comprehensive income (FVOCI)</td>
</tr>
<tr>
<td>Available for Sale loans</td>
<td>(There is not a classification in current GAAP)</td>
<td></td>
</tr>
<tr>
<td>Loans Held for Sale</td>
<td>Lower of cost or fair value</td>
<td></td>
</tr>
<tr>
<td>Trading Securities</td>
<td>Fair value, with changes in fair value recorded in net income</td>
<td></td>
</tr>
<tr>
<td>Certain other securities (EITF 99-20 securities)</td>
<td>Present value of cash flows</td>
<td>Fair value, with changes in fair value recorded in net income (FVNI)</td>
</tr>
<tr>
<td>Hybrid securities that were bifurcated</td>
<td>Host contract used amortized cost/embedded derivative used FVNI</td>
<td></td>
</tr>
</tbody>
</table>

* Accounting for Purchased Credit-Impaired Loans are largely discussed in ABA’s FAQ on FASB’s Impairment Exposure Draft [http://www.aba.com/Solutions/Acct/Documents/ABAimpairmentEDFAQsJan2013.pdf](http://www.aba.com/Solutions/Acct/Documents/ABAimpairmentEDFAQsJan2013.pdf) [TOP]

9. **Does “tainting” still exist for sales out of held to maturity (AC) securities?**

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\(^7\) Impairment for assets recorded at amortized cost and later identified for sale is based on fair value and not the expected loss.
This is a “good news/bad news” answer. Technically, there is no tainting of assets recorded at AC.

The good news is that in addition to credit-related sales, non-credit-related\textsuperscript{8} sales can happen out of the AC classification. Such sales are expected to be infrequent, but they are allowed. Total sales will be disclosed in the footnotes to the financial statements. Though the FASB intends to eliminate the tainting notion in this ED and replace it with disclosures about sales, we are concerned that this may be ignored by auditors in the future if there are large volumes of sales.

The bad news is that there is generally no reclassification of assets. Reclassification can occur only if there is a business model change, which is expected to be very infrequently. An example of a business model change would be a business combination. With that in mind, it is very important for banks to classify their assets at the time of purchase with a lot of forethought.

ABA believes this reclassification rule will be a challenge for banks with mortgage banking operations. In some cases, these banks originate mortgages with an intent to sell specific percentages of their production (retaining the remaining portion), rather than identifying specific loans to sell. Under current GAAP, such a situation is not normally a problem, as loans can be reclassified relatively easily after the bank sorts out what will be held and what will be sold. Under these banks’ business models, sales of loans are normally completed within about three months.

Under the proposal, reclassification is, for all intents and purposes, disallowed. This will be a challenge for banks, as their best guess may result in loans being classified in the wrong categories.  

\textit{10. If the default classification is FVNI, how do I make sure I avoid it?}

Once the cash flow test (solely principal and interest) is met, if the business model is both to hold assets for cash flows and to sell assets, then the asset (whether a loan or debt security) is classified as FVOCI—the assets are marked to market, with changes in fair value recorded in OCI (not through earnings). Bank liquidity portfolios and asset/liability management portfolios are “business models” specifically mentioned in the ED that would qualify as FVOCI.

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\textsuperscript{8} Within existing GAAP, held to maturity securities may be sold in certain circumstances without putting into question whether the portfolio is tainted. A common situation is when the security’s credit rating has been downgraded. Additionally, loans held for investment may be reclassified and sold in less restrictive circumstances.
11. **Given that the Basel III proposal punishes capital for unrealized gains and losses in the FVOCI assets, and there will be no tainting notion, shouldn’t I just stick everything into AC and remove all fair value volatility?**

It may be tempting. However, disclosures have been developed to replace the tainting notion and to permit investors, examiners, and auditors with the information needed to determine whether the intent of the rules is being followed. If there is a perception that the rules are not being followed, it is possible that the tainting notion will reappear on its own. Therefore, while ABA believes FASB moved in the right direction on this and banks will feel great operational relief, there will likely be little significant change in how banks classify their assets.

The recent Liquidity Coverage Ratio requirements approved by the Basel Committee are expected to be proposed in the U.S. These new requirements may result in an increase in the amount of assets that will need to be classified as FVOCI. So, the regulatory requirements may have a significant impact on decisions between AC and FVOCI classification. [TOP]

12. **We hold some equity securities. How does that change?**

Equity securities under the ED are generally marked to market – FVNI, with no option to hold them as FVOCI as current GAAP provides. There is a practicability exception for investments that do not have a readily determinable fair value. Such investments are valued at cost, adjusted for impairment and changes in fair value resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.⁹

Equity method accounting will continue, though there are specific indicators that must be reviewed to determine whether the investment is considered to be held for sale and, thus, to be recorded at FVNI. The Fair Value Option is also eliminated for equity method investments. [TOP]

13. **We securitize loans. Are there provisions we should know about?**

Banks that securitize loans, but are required to consolidate them on the balance sheet, will find some relief. Under current accounting, for securitizations that are accounted for as “secured borrowings”, estimating loan losses must take into consideration losses on the whole security – even though portions of the security may be held without recourse by third parties. Losses that are expected to be sustained by the third party security holders cannot offset the losses on the consolidated books for practical purposes, until the security terminates. In other words, securitizing banks must recognize losses they are not liable for.

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⁹ The current practical expedient to use net asset value for most investment companies will continue to exist.
The ED appears to remedy that, as nonrecourse financial liabilities are measured on the same basis as the related assets. Therefore, the liabilities related to third party security holders will be adjusted for the portion of expected loss related to those shares. [TOP]

14. With this and the impairment exposure draft, will this be the end to FASB’s changes to bank accounting?

No. FASB must still address hedge accounting and is expected to do so upon completion of this project and the impairment project.

ABA believes that FASB must also address fair value accounting as it relates to business combinations (mergers and acquisitions). Current GAAP requires all assets and liabilities of the acquired entity to be measured at fair value. Because of liquidity discounts inherent in most loans (whether impaired or not impaired), and especially those held by community banks, loan fair values are severely discounted during the fair value estimation process, resulting in significant “goodwill” to be recorded. As goodwill is not allowed within regulatory capital, the merger of two healthy banks can result in significant additional capital to be required. Further, net interest income then becomes artificially inflated in the future, as these discounts are accreted back into income over time.

With the cost burdens introduced by Dodd-Frank requirements, community banks may begin to investigate mergers. ABA strongly believes this accounting does not make sense – the economics of each loan have not changed. The combined bank will continue to pursue collection on the pre-combination balances and the loans will continue to be serviced and managed by virtually the same organization as before. Therefore, why is additional capital required? Both bankers and bank investors are confused with the current accounting. ABA believes there are several paths in addressing this. However, the FASB must first agree to initiate project on this topic, which ABA supports. [TOP]

15. What is the effective date, and how will transition be handled?

FASB has not determined the effective date. A cumulative-effect adjustment will be required on the first day of the reporting period in which it is put into effect.

ABA believes that the effective date will coincide with the effective date of the loan impairment standard that has been proposed (which also does not identify an effective date). We anticipate an effective date no earlier than January 1, 2015, though it is possible they could leave the door open to allow early adoption. [TOP]
16. What can I do to be involved?

For ABA member banks, ABA has an accounting committee to help identify the impact on individual banks and to help develop ABA’s comment letter. Please contact Nora Colbert (ncolbert@aba.com; 1-800-BANKERS) to join this group.

For investors, both FASB and ABA are performing outreach to gather feedback and discuss the advantages and disadvantages to making such a change. Contact Mike Gullette at the ABA (mgullette@aba.com) for more information. [TOP]

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