AMERICAN BANKERS ASSOCIATION

1120 Connecticut Avenue, NW
Washington, DC 20036

1-800-BANKERS
www.aba.com

World-Class Solutions, Leadership & Advocacy Since 1875

Michael L. Gullette
VP – Accounting & Financial Management

Phone: 202-663-4986
Fax: 202-663-5209
Email: mgullette@aba.com

September 14, 2009

Sir David Tweedie, Chairman
International Accounting Standards Board
First Floor 30 Cannon Street
London, EC4M 6XH
United Kingdom
Via email: iasb@iasb.org

File Reference: Exposure Draft *Financial Instruments: Classification and Measurement*

Dear Sir David Tweedie:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Exposure Draft *Financial Instruments: Classification and Measurement* (ED). ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

In summary, ABA supports the IASB's efforts to review the basis for mark to market accounting (MTM) and to simplify the accounting for loans and securities. Specifically, we agree with what we believe to be the basic premises of the ED:

- Portions of an entity that originate/buy and sell/securitize loans and securities, as well as trade for profit, should use MTM through earnings.
- Portions that utilize a traditional banking business strategy should use amortized cost to account for loans and securities. Any changes in fair values of those assets should be disclosed only in the footnotes.
- Current tainting rules that cause portfolios to use MTM should be discontinued.

However, while it appears that the ED recognizes the importance of a financial institution's business model in determining the classification of assets, we have the following major concerns:

- The language used to enable an entity to measure an asset at amortized cost – that the instrument has "basic loan features" and is "managed on a contractual yield basis" – must be refined or it will cause confusion in accounting practice.
- Assigning MTM to non-senior tranches of structured securities and to assets purchased with "discounts reflecting incurred losses" appears to be arbitrary and

the seems to ignore the main business of banking – managing cash flows related to various credit risks. Organizations can manage these risks through use of collateral, risk-based pricing, and skilled servicing. Classifying and measuring these assets as MTM will often inappropriately lead investors to believe that the assets will be settled at market value rather than from the contractual cash flows and that they are necessarily "high risk".

- The Board must address the confusion in the investment community regarding purchased loans. The elimination of allowances for losses, whether the loan is considered "individually" or "collectively" impaired, continues to perplex users of the financial statements as to the comparability of the credit quality of various loan portfolios. We recommend that applicable reserves may be carried over for those loans carried at amortized cost, with an adjustment made only for movements in interest rates.

In addition to our comments on the technical aspects of the ED, we have serious concerns that the current process of classification and measurement is being conducted separately from the evaluation of impairment of loans, as well as hedge accounting. We believe that conclusions may change if the issues were addressed in a comprehensive fashion at once. Depending on the conclusions reached regarding impairment, our analysis of this phase of the project could take on a different perspective. For example, carrying over loss reserves on purchased loans might appear to be the only appropriate treatment if impairment is measured on an expected loss basis.

We are also very concerned that the logistical coordination on this joint project with FASB is out of sync and that the content of the two proposals are different – and are not aligned with input from the banking regulators (through the Basel Committee on Banking Supervision). We believe it is extremely important that the Board and the FASB work together and with banking regulators to ensure that new standards relating to financial instruments are truly a joint effort. Per the "Meeting of Finance Ministers and Central Bank Governors, London, 4-5 September 2009: Declaration on Further Steps to Strengthen the Financial System," the G-20 emphasizes the importance of:

> "Convergence towards a single set of high-quality, global, independent accounting standards on financial instruments, loan-loss provisioning, off-balance sheet exposures and the impairment and valuation of financial assets. Within the framework of the independent accounting standard setting process, the IASB is encouraged to take account of the Basel Committee guiding principles on IAS 39 and the report of the Financial Crisis Advisory Group; and its constitutional review should improve the involvement of stakeholders, including prudential regulators and the emerging markets."

Based on the different schedules that the Board and the FASB are keeping, and the different approaches proposed thus far, it appears highly likely that the process will not result in convergence. Additionally, specific portions of the ED, if approved, will directly contradict the Basel Committee's guiding principle that the IASB's approach "should not result in an expansion of fair value accounting." It appears that coordination of the ED with banking regulators has not been effective.

Further, while the G-20 has endorsed the Financial Stability Board's (FSB) analysis and recommendations on procyclicality, the ED's proposed expansion of fair value accounting seems to ignore the FSB's observation in its April 2, 2009 "Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System," that:

> "A number of developments in financial systems – including increased direct and embedded leverage, leverage funded with short-term debt, more marketable assets, and extensive application of fair value accounting – have contributed to an increase in the procyclicality of the system."

With all this in mind, we recommend that much closer coordination with the FASB and with the banking regulators be a priority as the financial instruments project proceeds.

Attached to this email transmission are our earlier letters and white papers, which include further information about our views on the technical topics as well as the process for establishing new accounting standards for loans and debt securities.

Attached are our responses to some of the questions asked in the ED.

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

Michael L. Gullette

Attachments

<u>Specific Responses to Selected Questions in the ED</u>

Amortized Cost Accounting Provides Decision-useful Information for the Traditional Banking Operation

> (**ED question 1:** *Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?*)

In traditional banking operations, deposit liabilities typically provide funds for loans and securities that are held long-term for the purpose of earning interest margin spread. In this portion of the business, assets should be recorded based on what provides a relevant indication of future cash flows – amortized cost. Amortized cost valuations approximate the principal cash flows that a banker is owed. It not only provides an accurate and easy-to-understand indicator of future cash flows and yield, when it is accompanied by a robust impairment accounting model, it effectively provides investors with the net amounts expected to be collected. The amortized cost model provides the investor with management's view of these investments will be settled. For parts of the bank that buy and sell loans for profit, MTM is appropriate. However, for the traditional banking operation, amortized cost is the only relevant indicator of bank performance.

The Terms "Basic Loan Features" And "Managed on a Contractual Yield Basis" Will Cause Operational Problems and They Arbitrarily Assign Fair Value Measurement to Certain Debt-Based Assets

> (**ED question 2:** Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?)

"Basic Loan Features" must be better defined

We appreciate the Board's effort to provide guidance as to when an asset qualifies for amortized cost accounting. However, the terms used (the instrument has "basic loan features" and "is managed on a contractual yield basis") will prove to cause problems both for users and auditors. The descriptions of "basic loan features" in the ED's Appendix B, paragraphs B3 through B5, are confusing and invite ongoing questions regarding both existing and future lending products, and have the potential to stymie future product development.

For example, we believe that credit card receivables with interest rates based on borrower balances will qualify as a basic loan feature because the balance is often an indicator of higher or lower credit quality (this appears to satisfy paragraph B3(c)). However, whether "credit deterioration" must be confirmed or projected is not clear in the ED. Another example is the option adjustable rate mortgage (Option ARM), where borrowers may pick their payment amount, as long as that amount exceeds a minimum amount, which can be less than the amount of accrued interest. We believe that some construe such terms to be outside the description of "basic loan features". However, certain people may argue that the change in the amount of payments "protect the creditor or debtor" as described in paragraph B1. Therefore, because MTM does not reflect the cash flows for traditional banking, controversy over whether or not a product has "basic loan features" is likely to occur. Additionally, products with "basic loan features" may be developed soon after the effective date to replace existing products – simply in order to enable an entity to use the accounting that better reflects cash flows

MTM for non-senior tranches of structured securities ignores the traditional substance of the transaction

The proposal to assign non-senior tranches of a structured security to MTM is the result of "leverage" derived from providing "credit protection" to other investors. This approach appears to ignore how, through the use of collateral, credit risk is routinely managed by banking institutions on a continuous basis. In these structures, subordinate investors are not providing "credit protection" to senior holders. They are receiving a specific yield based on the level of additional collateral included in the structure (collateral being the level of losses to be assumed by lower tranches, the effects of over-collateralization within the structure, and any other credit enhancements – all of these are in addition to the collateral underlying each loan within the security). Senior tranche holders merely have additional collateral. In a significant number of structured securities, non-senior tranches are rated AAA at issuance. Therefore, even if we accept the rationale behind the Board's approach, the "credit protection" provided by these investors is nominal. From a practical perspective, we do not see a difference between these securities and any other subordinated debt security.

"Managed to a contractual yield basis" needs clarification and should include purchased assets acquired with discounts reflecting incurred losses.

We appreciate the Board's recognition that a company's business model is a key factor in determining the proper accounting method. However, term "Managed to a Contractual Yield Basis" invites operational questions. Financial institutions that are not managed through fair value generally manage net yields and margins and their associated cash flows, rather than contractual yields. Net yields, of course, are affected by changes in general interest rates, and credit conditions. Yields may also be affected by routine asset/liability management activity.

The emphasis on contractual yield appears to be the Board's way to ensure that loans or securities that have been "acquired with discounts reflecting incurred credit losses" will be accounted for with MTM. While these assets may inherently contain greater risk, the contention that these loans and securities must be treated like a derivative or equity instrument does not reflect the standard business practice of requiring higher yield (reflected in the discount) for higher risk. Organizations that acquire impaired loans should not be required to report these at fair value. Their intent often is to manage the contractual cash flows of these loans (which, after deducting the losses and servicing costs they expect, results in a net yield).

Additionally, the concept of "incurred" losses is open to operational questions as to whether the incurred loss event has been reported and how that event is defined. For example, a general interest rate increase may possibly be considered an incurred loss event on a fixed rate loan if management believes that the borrower's cash flow is sufficiently reduced by increases in the rates of the borrower's other available credit facilities. While the interest rate increase may give rise to a credit rating adjustment on the borrower, it is questionable whether an incurred loss has occurred. Experience with FASB Statement 141R *Business Combinations* also causes us to further question whether such discounts must be based solely on individual impairment or collective impairment.

Finally, depending on the results of the Board's efforts in considering an "expected loss" impairment model, if companies are asked to measure impairment for assets accounted for at amortized cost using an expected loss or expected cash flows methodology, processes to identify "incurred" losses may not be readily available.

Recommendations

With these considerations in mind, we recommend that the criteria to describe business model be changed so that the instrument is "managed to receive the contractual cash flows". We believe it better captures how traditional banks manage their portfolios.

Under this wording, it is reasonable to believe that assets purchased with discounts reflective of incurred credit losses are indeed managed to receive the contractual cash flows. However, we also believe that the Board should take a comprehensive look at how loans, in general, are recorded upon initial recognition. With the elimination of credit loss reserves for loans measured both individually and collectively, investors are constantly confused as to loan performance. Unusually high yields that reflect market-related discounts are misleading investors, who normally want mere charge-off and standard loan loss reserve information. Under the current accounting rules in the U.S., these reserves are not indicative of the exposures on these acquired loans. We recommend that loan loss reserves be carried over during business combinations, with market value adjustments disclosed in the footnotes.

We believe that non-senior level tranches of a structured security should only be at MTM if they are not managed to receive the contractual cash flows. Just because the perceived risk of a loan or debt security is high does not mean that the asset requires derivative-like treatment. However, if it is the Board's objective to capture risk and variability by specifically identifying for MTM the non-senior level tranches of a structured security, as well as assets purchased at a discount that reflects incurred credit losses, then we recommend that such assets be clearly disaggregated and disclosed, describing the general structures and underlying collateral.

The Business Model should Determine the Accounting Method for Other Assets

(**ED question 3:** *Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost?*
(a) If so, what alternative conditions would you propose? Why are those conditions more appropriate?

(b) *if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?)*

A company's business model or intent should be the primary driver of whether amortized cost should be utilized, since that is normally how core earnings are derived and how management is judged by its Board and shareholders. With that in mind, we believe certain credit enhancement assets acquired to hedge loans or debt securities should be accounted for consistent with the portfolio in which those assets reside.

The Fair Value Option should be Retained and Useful for Any Purpose

(**ED question 5:** *Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?)*

(**ED question 6**
Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?)

The Fair Value Option should be permitted for any reason as long as that reason is adequately disclosed in the notes to the financial statements. As there are different ways that companies manage their business and are evaluated by their investors and Board of Directors, companies should be able to reflect this intent within the financial statements. While we believe this will reduce the so-called accounting mismatches, it should better reflect the performance of management in achieving its financial objectives.

Reclassification should not be prohibited

(**ED question 7:** *Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?)*

Reclassification of an asset between the fair value and amortized cost accounting methods should not be prohibited. There may be circumstances in which reclassifications are warranted, and, if so, those circumstances should be clearly disclosed in the footnotes.

It is common for banks to enter into agreements with government sponsored entities (GSEs) to originate and sell loans to the GSEs, dependent on specific execution terms. In certain circumstances, execution cannot occur and those loans, which management initially intended to sell, may then be reclassified for long-term holding. Among other things, these circumstances include large changes in the interest rates that put either party at a significant disadvantage, as well as the bank's inability to generate the agreed-upon loan volume. For accounting purposes, these loans are currently reclassified from Lower of Cost or Fair Value accounting to amortized cost accounting when it is determined that they will not be sold. This process normally occurs during a one to six month time period after origination. This is a legitimate change in business intent in which reclassification should be permitted. For practical purposes, "seasoned" loans (those greater than a certain age since issuance) have a relatively scarce market and are normally held for the contractual cash flows. Therefore, sales of seasoned loans are not common.

In addition to the above situation, changes in ownership, business model, or product mixes are examples of circumstances in which reclassification should be permitted. These are significant reorganizations that deserve significant disclosure.

The Effective Date Must be Uniform with More Guidance to Assist U.S. Preparers on Fair Value Issues

> (**ED question 13:** *Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?)*

We believe that, no matter the transition time, there will be significant investor confusion resulting from these changes. Allowing certain companies to begin reporting based on this standard will only cause further confusion within the capital markets. In financial service industries and others subject to heavy regulation, misinterpretation of results can cause additional problems that are unwarranted. Therefore, we urge the Board to not permit early adoption of these principles.

In order to apply the proposal retroactively, we believe that more guidance will be required across a broad spectrum of issues as implementation begins. For example, guidance around fair value measurements, sales accounting, and variable interest entities should be considered if those outstanding issues are resolved by the Board prior to the effective date.