

May 14, 2013

Hans Hoogervorst, Chairman
International Accounting Standards Board
First Floor 30 Cannon Street
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Leslie Seidman, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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RE: IASB Exposure Draft: *Financial Instruments: Expected Credit Losses*
FASB File Reference No. 2012-260: *Financial Instruments – Credit Losses*

Dear Chairman Hoogervorst and Chairman Seidman:

The American Bankers Association (ABA)¹ appreciates the opportunity to comment on the financial instruments credit loss exposure drafts issued by the IASB and the FASB (EDs). We are submitting our detailed comments on your individual proposals in separate letters, and the purpose of this letter is to describe our recommendations for a joint path forward on credit losses.

A path forward for both boards

ABA continues to support meaningful efforts to converge impairment standards on a world-wide basis. We believe the Banking Industry Model (BIM) is the best alternative for a converged impairment model, and we regret that the Boards chose not to use the BIM as the basis for their exposure drafts. If the Boards choose not to use the BIM going forward, several modifications to the EDs will help improve the impairment standard so that it can be implemented by banks world-wide in a more efficient manner.

Recommendations if converging toward the FASB model:²

1. Omit the requirement that net amortized cost reflect the present value of future cash flows (PV).

This requirement evolved from the previous agreement between the boards on “expected value” (which generally represents a probability-weighted present value calculation). We believe it is the source of the life of loan (LOL) concept, as the present value notion as practiced within current GAAP entails detailed estimates of cash flows throughout the life of the loan. Additionally, it resulted in confusing language

¹ ABA brings together banks of all sizes and charters into one association. ABA represents banks of all sizes and charters and is the voice for our nation’s \$14 trillion banking industry and its two million employees.

²The recommendations related to the FASB’s CECL model generally also apply to the IASB model. The IASB model is understood to require life of loan (LOL) loss calculations for all loans in a portfolio. However, the estimate for those “Stage 1” assets is performed by applying a one-year probability of default factor to this LOL amount. Migration to “Stage 2” is generally based on deterioration in lifetime probability of default.

and guidance in the FASB ED to demonstrate that various methods can “implicitly” reflect “multiple outcomes” and the “time value of money.”³

We believe that financial statement users are interested in what will/will not be collected with regard to principal, and an amortized cost balance needs no explanation. The inclusion of PV theory unnecessarily complicates that process, and it should be removed from the ED.

Along with removing the PV language,⁴ the related LOL language should also be removed. In its place, banks would provide estimates based on their best actual “expectation” (that which is estimated with reasonable confidence) without requiring them to base their estimates on historical LOL loss averages.⁵ With this in mind, reference to using historical loss data as a “starting point” should be omitted.⁶ Historical loss data is one of several tools that may be used in estimating credit losses.

2. Reaffirm the most important features of an expected loss model.

The two biggest changes from an incurred loss model to an expected loss model are the elimination of the incurred loss model’s “probability threshold” and the CECL model’s requirement that an estimate reflect both the possibility that a credit loss results and the possibility that no credit loss results. Emphasizing these two aspects simplifies the standard to that which can be easily implementable. Although the ED states that the single best estimate should not be used, we believe the single best estimate within a reasonable range should be used and should be included in the standard.

3. Expand the definition of “expected credit losses”

The current definition should clarify that amortized cost is the basis from which credit losses are estimated. Therefore, in addition to the definition in the FASB ED, “*An estimate of all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit*”, the following should be added:

³ ABA believes the deferral and amortization of net deferred loan fees/costs cause the balance to not necessarily reflect the present value concept. Additionally, the “nonaccrual” concept may undermine the PV concept, as accrued income is both omitted from the recorded balance and from credit loss calculation.

⁴ ABA is not recommending that discounted cash flow (DCF) analysis be disallowed, but that the requirement to effectively measure using present value should be omitted. In fact, a DCF analysis can be used as a tool to estimate expected losses.

⁵ ABA believes that if historical LOL averages could reliably reflect accurate losses, then such data could be used as primary support for such balances. However, historical data should be used merely as a factor and relied upon when applicable. With this ED, it appears that current GAAP has moved from a loss “must be probable and estimable to record a loss” to CECL’s “must prove the loss isn’t already there.” Without a PV notion, losses estimated with reasonable confidence are recorded without the necessity to forecast activity in future periods that are beyond the capability of most banks.

⁶ While the ED does not assume historical losses will be used as a “starting point,” the Frequently Asked Questions published by FASB on March 25, 2013 refers to this.

“For those assets recognized on the balance sheet, this will generally be based on the net amortized cost balance. For those commitments to extend credit, this will generally be based on expected extensions of credit.”

4. Provide implementation guidance that assists in the use of forward-looking information.

While one of the objectives of the project has been to implement a model that uses more forward-looking information than the current impairment model, there is no guidance within the FASB ED on what information is considered “forward-looking” nor is there assistance on how such information would be used. We assume that FASB considers the nature of the CECL model to be “forward-looking” since it requires lifetime expected losses to be recorded on day 1. However, there is a significant problem, as use of historical data is, by nature, backward-looking, and there is no guidance in the ED on how to determine whether adjustments from the historical data (presumably, to create forward-looking estimates) are required (or, for that matter, determining whether historical data should be relied upon at all).

As a result of this omission, we believe that, while they may be relatively higher, allowances under the CECL will be no more forward-looking than the current incurred loss model as it is practiced today.

Forward-looking information should focus primarily on the identification of circumstances and events that can change future loss expectations. The “forward-looking loss event” guidance that is part of the BIM and outlined in this comment letter is a good start, though the joint standard should emphasize that the main objective is to identify events, conditions, and metrics, whether on macroeconomic or on a borrower-by-borrower basis, that assist in forecasting future charge-offs. Finally, since forecasts of the future will be the biggest source of volatility in the allowance balance, guidance is needed in what will be considered “reasonable and supportable forecasts.” Such guidance should address in detail the limits of long-term forecasting during certain stages of an economic cycle as well as how far into the future these forecasts should go.

We believe such information is essential – without it, financial institutions will likely be accused of earnings management during economic expansion and being slow to change expectations heading into a contraction. In other words, the same criticisms will be leveled at the CECL model as the current model in the absence of such guidance.

Recommendations if converging toward the IASB Model:⁷

1. Generalize the concept of “loss” to recognize diversity in banking practice around the globe.

The IASB model effectively requires that the LOL impairment be estimated for the entire portfolio, as required by the CECL. For those loans that have not experienced significant credit deterioration (Stage

⁷ See footnote 1. Additionally, a fuller analysis of the IASB model is included in ABA’s comment letter to the IASB.

1 loans – as measured by the change in lifetime probability of default), the 12 month probability of default is applied to the LOL loss.

The concepts of probability of default and of LOL for unimpaired loans are not used by the vast majority of U.S. banking institutions. Instead, U.S. banks focus on estimating charge-offs through loss emergence periods (which often generally equate to 12 months for unimpaired consumer loans and a longer period for unimpaired commercial loans) and not on estimating LOL losses or defaults (though defaults may be included in the analysis for expected future charge-offs). Requiring the PD/LOL approach in order to satisfy practice outside the U.S. would be costly for U.S. preparers without measurable improvement to impairment accounting. Therefore, if Stage 1 is retained, the approach for estimating needs to be built upon existing practices of estimating an allowance for unimpaired loans.

2. Reconsider the measurement basis for Stage 1 loans.

The overall intent of the IASB’s ED is somewhat similar to that of the BIM, because they both are meant to respond to credit deterioration. However, the strict 12 month expected credit loss measurement for Stage 1 loans does not appear to have a theoretical basis, and it may result in lower allowance balances for some portfolios than U.S. banks believe are prudent.⁸ For example, it represents a period of time that U.S. banks often currently exceed in their allowance estimates for some commercial loans. For these reasons, we believe the ED would not represent an improvement over the current impairment model.

Instead, Stage 1 loss measurement could be defined as a “minimum of 12 months losses” or by eliminating any minimum requirement altogether for Stage 1 loss measurement.⁹ Comparability could be achieved through adequate disclosure of corporate allowance objectives and how recorded losses relate to the targeted time periods. In either case, financial statement users, including regulators and investors, have the basis (through the disclosures) to better compare reserve adequacy levels.

3. Alleviate “staging” rules by relegating the Stage 1 and Stage 2 requirements to “implementation guidance.”

The ED generally differentiates Stage 1 and Stage 2 loans based on conditions that present higher credit risk to specific cohorts of a portfolio. ABA agrees that various events and conditions can, looking forward, increase credit risk and, where this increase is meaningful, should be provided for through relatively higher allowances. With that in mind, however, we anticipate serious operational and audit challenges by the requirement to classify loans into one or the other stage. These challenges include:

- Tracking individual loans or cohorts in the appropriate stage (essentially creating a closed portfolio).

⁸ Whether the ED represents larger or smaller reserves than current U.S. GAAP depends largely on the timing of transfers between Stages 1 and 2.

⁹ If no time period is defined for Stage 1 assets, we believe that regulators in each jurisdiction will have a significant influence over the allowable period of time.

- Similar loans in the same geographic region and credit risk profile may be classified in two different stages, based on the timing of loan issuance (assuming the risk is priced correctly at issuance).
 - Loans to the same borrower may be classified in two different stages, based on the timing of the loan issuance.
- Determining specific thresholds in which migration between stage 1 and stage 2 occurs, both at a loan level and at a cohort/portfolio level (assuming these thresholds should not conflict).

The staging process, which is at the heart of ED, is helpful as guidance on judging when significant credit deterioration has occurred. However, requiring it as part of the measurement and disclosure processes is unreasonable for all but the most sophisticated banks.

Thank you for your attention to these matters and for considering our views on this important banking industry issues. Please feel free to contact Mike Gullette (mgullette@aba.com; 202-663-4986) or me (dfisher@aba.com; 202-663-5318) if you would like to discuss our views.

Sincerely,

A handwritten signature in cursive script that reads "Donna J. Fisher".

Donna J. Fisher