

May 14, 2013

Leslie Seidman
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
Via email: director@fasb.org

RE: File Reference No. 2012-260: *Financial Instruments – Credit Losses*

Dear Chairman Seidman:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Exposure Draft: *Financial Instruments – Credit Losses* (ED). 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.

Accounting for credit losses (also referred to as impairment) is, without a doubt, the heart of bank accounting. As a critical part of our economy, banks are financial intermediaries that are closely supervised by various regulating agencies at both the federal and state levels, and are tasked with the role of providing credit to individuals and businesses of varying levels of creditworthiness. Within this role, banks' assets consist primarily of loans, and an important component of the banking business is to manage the credit risks that each borrower presents. Accounting for credit risk, and the credit losses that ensue on these loans, is what helps users understand the quality of banks' loans. Getting impairment accounting right – or as right as it can possibly be, considering the significant amount of judgment that is required in evaluating any credit risk – is a critical component for understanding bank financial statements.

Creating an accounting standard for credit losses is a very tough and intricate issue, as recognizing and measuring credit losses is inherently surrounded by judgment. It is then complicated by the different interests of short-term and long-term investors, the objectives of prudential banking regulators and the Securities and Exchange Commission (SEC), as well as the audit requirements of the Public Company Auditing Oversight Board (PCAOB). An impairment model can have economic policy implications, as the timing of credit loss recognition can alter the rate of return of lending and, thus, the cost of credit. Further, differences in international banking laws, practices, and products – as well as differing and strongly held views about when the appropriate time is to begin providing for losses – has resulted in roadblocks for creating a globally accepted standard.

The need to address credit losses was amplified during the Financial Crisis, as concerns about provisioning “too little, too late” were echoed by many, including world-wide banking

regulators. This ED represents the fifth impairment model presented since 2010¹, and while some may criticize FASB and the International Accounting Standards Board (IASB) for not yet finalizing a standard, ABA applauds both boards for taking the time to “get it right”. With this in mind, ABA urges that careful deliberation continue to be conducted going forward.

ABA applauds FASB for making the decision in September 2012 to address questions and concerns from banks and users of their financial statements about the joint FASB/IASB impairment model. This, along with the FASB’s outreach efforts, has demonstrated the FASB’s commitment to developing the most appropriate standard for both bankers and bank investors. As FASB deliberates on the comment letters received, ABA is encouraged with the expectation that the Board will continue with the same approach.

CECL Model vs. BIM

While the different models exposed for comment over the past three years have varied greatly, ABA has been consistent with our message to the FASB, regulators and bank investors. This letter contains a continuation of that message, which is that the U.S. Banking Industry Model (BIM) is an improvement over current GAAP as well as over the other models discussed to date. This letter provides much more detail about the BIM in order to demonstrate how it addresses concerns that have been expressed as well as how it would improve loss recognition and transparency, and make the impairment model operational. This letter also compares the BIM with the current expected credit loss (CECL) model. Because of the deep challenges we see for both bankers and investors for operationalizing and applying the CECL model, we believe that the BIM provides the most effective step forward.

Our views about the two models are:

- The CECL impairment model described in the ED is generally perceived to be a life of loan² (LOL) model. Such a model will not necessarily provide the most useful information. Generally, we believe it will:
 - Delay loss recognition in times of financial distress and unnecessarily increase volatility, adding procyclicality to the financial system,
 - Mask credit risk transparency, because deterioration that is “expected” will not result in additional loss provisions,

¹ In 2010, FASB and IASB proposed different impairment models, which was followed by a joint Supplementary Document that introduced a hybrid of two models. Subsequent to the issuance of this ED, IASB has issued its impairment model for consideration. This letter will address certain key parts of that model. However, ABA will provide detailed observations and recommendations related to the IASB model in a separate comment letter to the IASB.

² It is noted in the Basis for Conclusions (paragraph BC 18), that the Board decided not to characterize expected credit losses as “lifetime” expected credit losses, because the term is interpreted in different ways. The paragraph notes that it: “may lead some to believe that an entity must identify the exact amount and timing of uncollectible cash flows in each year of the asset’s life for use in a discounted cash flow technique...”. Although the Board avoided using the term “lifetime,” the ED is being read as meaning “lifetime.”

- Be very difficult to support the estimates, since historical averages are made up of widely divergent results,
- Render all historical loss metrics as irrelevant and perhaps make prospective metrics harder to compare,
- Require enormous and costly operational change,³ and
- Potentially wreak havoc with FASB’s own conceptual framework of accounting.

The BIM (initially introduced in 2011) is the best path toward an internationally converged solution that responds to concerns of bankers, bank investors, and banking regulators by:

- Discontinuing the “probable loss” notion.
- Providing appropriate guidance in understanding the loan impairment process, “loss events,” and “forward-looking loss events,” as well as additional disclosures to assist users in understanding the processes and comparing them between companies.
- Recognizing subliminal risks that build during an economic expansion in a transparent fashion.
- Retaining impairment accounting within the FASB conceptual framework by recognizing impairment only when a loss event is believed to have occurred.
- Building on current systems and financial metrics, rather than wholesale change.

While the “probable notion” of the current incurred loss model does delay certain loss recognition, “earnings management” concerns, along with a reliance on loss rates repressed by a long period of growth in property values, were also responsible for repressed allowance levels before the Financial Crisis. We believe a new impairment model that builds on bankers’ knowledge about credit risk (as opposed to over-reliance on statistics that may not be accompanied by a specific confidence level), provides a more forward looking approach than the current incurred loss model, builds on existing systems, minimizes transition time and cost, and allows ongoing refinement by both bankers and regulators, is what is needed. The BIM fits these criteria.

We believe that the objectives of the BIM are not different from the CECL. For example, when one reads the text of the ED, it is not obvious that the CECL is a LOL impairment model. However, we believe significant changes must be made to the ED in order to conform the CECL to a workable and usable model that complies with FASB’s conceptual accounting framework. Foundationally, this includes deleting the emphasis on the “expected value” measurement concepts of probability weighting and present value, as well as providing guidance on loss events. With that in mind, however, we believe that examination of the BIM model is the most efficient path to a solid and converged impairment model.

Other Important Comments

- Debt securities should not be included in the scope of the ED. Instead, only small change to the current OTTI model is necessary for debt securities.

³ And, for community banks as well as some other banks, it could remove much of the estimation process from the bank and place it in the hands of outside experts and their models.

- The proposed change to accounting for purchased credit-impaired (PCI) loans is a significant improvement to current standards. The same accounting should apply to all purchased loans, including those acquired in a business combination.
- The troubled debt restructuring (TDR) designation should be discontinued, with more informative disclosures proposed.
- The inclusion of the nonaccrual principle in the ED is supported. However, coordination with the ultimate impairment principle will be required. Further, the specificity around the alternative methods for recognizing interest income related to cash received while in nonaccrual status is not necessary.
- Roundtable discussions should be held with all constituents before finalizing required disclosures. The FASB should also consider holding a public meeting with the Public Company Accounting Oversight Board (PCAOB) prior to finalizing the standard, so nothing is lost in subsequent interpretations of the standard.
- At least four years will be required to transition to the CECL, though only two years for the BIM.
- Efforts to agree on a high-quality, global impairment standard should continue.

Detailed Comments

In the attachments to this letter, ABA provides detailed explanations related to the above points. Brief summaries of the attachments are as follows:

- Attachment 1: Background and Problems with the CECL Model

Regulators are concerned with safety and soundness. Investors, however, mainly want loan loss provisions to reflect meaningful changes in the probabilities of default and loss exposure. They are concerned about transparency and about comparability, if not between banks, then between periods for individual banks. While there is initial appeal to a life of loan impairment model, detailed analysis causes us to conclude it would not satisfy user needs, would be very costly to implement, and would not comply with FASB's own conceptual framework.

- Attachment 2: The U.S. Banking Industry Model for Impairment (BIM) and Loss Emergence Periods

The BIM addresses user concerns and would be much less costly to implement. In addition to abolishing the "probable notion" for loss recognition, significant guidance related to loss events (including "forward-looking" loss events) and loss emergence periods is provided. Thus, the BIM would comply with the FASB conceptual framework and alleviate "Day 1 loss" concerns that currently represent the biggest hindrance to global convergence of accounting standards. The Credit Risk Adjustment (CRA) feature of the BIM also represents the only significant improvement proposed over the current impairment model.

- Attachment 3: BIM and Common Concerns

The BIM is shown to address all relevant losses, based on the reliability of estimates of the risk of loss and of loss exposure. The BIM also avoids primary reliance on historical data that is unreliable for the purpose of estimating loan impairment at specific points in time. The term, “foreseeable future,” is clarified defined for use in BIM.

- Attachment 4: Detailed Comments on Other Important Aspects of the ED

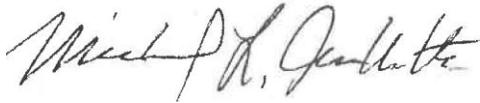
Recommendations relating to other aspects of the exposure draft (also listed above under “Other Comments”) are addressed in detail.

- Attachment 5: Answers to Specific Questions Noted in the ED

In a “question and response ” format, the questions asked in the ED are addressed.

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

Sincerely,



Michael L. Gullette

ATTACHMENT 1: BACKGROUND AND PROBLEMS WITH THE CECL MODEL

What Financial Statement Users Need

In the aftermath of the global economic crisis, delayed recognition of credit losses associated with loans (and other financial instruments) was identified by some as a weakness in the application of existing accounting standards. Because the existing incurred loss impairment model is understood to delay recognition until a credit loss is probable (or has been incurred), the FASB and the IASB have been exploring alternatives to the current impairment model that would use more forward-looking information.

In our outreach to the main users of bank financial statements, ABA has identified the following objectives that users cite for an ideal impairment model:

Banking investors:

1. Changes in the general probabilities of loss and of loss exposures should be reflected in the allowance for loan and lease losses (ALLL). This is not meant to be a strict mathematical exercise.⁴ However, when meaningful risk and exposure change, it should be reflected in the ALLL.
2. The economics of the lending business should be reflected. There is pause from investors when they are asked whether losses several years in the future should be reflected at origination, though interest income earned over the term of the asset will more than make up for a loss recorded at origination.
3. The impact of key judgments related to forecasts should be generally understood. For example, if the company believes that economic risk may be building during an economic expansion, they would like to understand that and its effect on the ALLL. Again, this is not meant to be a specific, traceable, calculation.
4. There should be comparability over time. Analysts heavily rely on historical data and trends to forecast cash flows in the future. Disruption to that analysis, based on accounting changes, as well as acquisitions of assets, is not desired. Differences between companies should be understood, and period-to-period differences of an individual company are highly desired.

Banking regulators:

1. With safety and soundness as an underlying objective to banking supervision, regulators are interested in linking credit management expectations to the financial statements.
2. Regulators believe that regulatory capital is meant to address “unexpected losses,” whereas the ALLL is meant to record “expected losses.”. As a result, regulators believe

⁴ This is also not meant to apply Basel II/III probabilities of default and loss given default calculations, which are based on historical ratios applied to stressed economic assumptions.

“life of loan” loss allowances, based largely on an entities’ own historical experience, should be recorded at origination.

3. Regulators have expressed a desire for the prompt recognition of risk due to systemic issues. For example, during an economic expansion, underwriting standards often decline, increasing the probability of default should the economic cycle turn.

Problems with Current GAAP

As noted, the main problem with the current impairment model is that an event must have occurred in which it is probable that a loss that is reliably estimable has been sustained. That “probable notion” limitation has been further compounded by a regulator’s efforts to curb “earnings management” in bank financial statements: high ALLL balances subjected bankers to the criticism that they were trying to “smooth future earnings”.

Such efforts resulted in reliance on models that were tightly bound to historical averages. While the banking regulators were advocating greater use of “qualitative factors” to recognize higher risk in loan portfolios, bankers and their auditors were hesitant to stretch the boundaries derived from the support of historical data. As a result, and in concert with a long period of relative growth in the overall economic environment (which reflected low loss history), ALLL levels were relatively low going into the financial crisis. Prime examples of the “too little, too late” syndrome include:

- Loan product with terms, such as payment spikes, that make collateral value a more critical factor in the process: Borrowers were performing as expected under the initial periods of the payment schedule. Higher losses, then, appeared likely to occur, as stagnant or declining property values put refinancing in question. Until it was “probable” that a “loss event” had occurred, however, the allowance would not be recorded.
- General subprime loan portfolios before the Financial Crisis: Underwriting standards were lowered and banks knew there were higher risks that should be recognized. However, historical data on such loans had not yet indicated that higher loss rates are “probable”. In this case, it was a combination of the “probable” notion, coupled with a reliance on past history as an indicator of current performance, which repressed timely recognition of losses.

Efforts Toward Convergence Resulted in Underlying Problems in the ED

Throughout their various deliberations related to impairment, FASB and IASB have attempted to agree on various foundational accounting concepts. ABA agrees that this is necessary and desirable. However, in doing so, the Boards omitted any discussion related to agreement on the foundation of the current impairment model, which is the definition and timing of the “loss event”. As noted later in this paper, we believe that agreement on how a “loss event” is defined is crucial to convergence of world-wide standards and in establishing a foundation for applying an “expected loss” impairment model within the Boards’ conceptual frameworks. Instead, the Boards pursued agreement with the concept of “expected value”; one that emphasizes probability-weighting of the present value of cash flows (also referred to as the time value of

money). In other words, while the main problem of the incurred loss model has been the timing of recognition of the loss, the Boards decided to focus on measurement.

Adherence to this concept has resulted in confusing implementation guidance within the ED that refers to definitions of default⁵ and unnecessarily attempts to prove that various impairment models consider “both the possibility that a credit loss results and the possibility that no credit loss results”⁶ and that they “implicitly reflect the time value of money.” We further believe that this insistence on adhering to the “expected value” concept has cornered FASB into proposing an accounting model much closer to a fair value model.⁷ Hence, the CECL is understood as a life of loan (LOL) model,⁸ with the only practical difference from fair value for most banks being the discount rate applied to assumed losses for market-specific factors such as liquidity, the price of credit, and interest rate changes. Therefore, while FASB’s primary objectives in this impairment project were to remove the perceived constraints of timely loss recognition and require consideration of a broad range of information in the process, FASB has proposed an LOL model that, among other troubling things, emphasizes expected value measurement.⁹

Life of Loan Model Will Not Address User Needs

As we reflect on the experience in the U.S., a change in the current GAAP standard for “incurred loss” has been needed for a long time.¹⁰ However, ABA believes potentially louder criticism would have been heard during the Financial Crisis under an LOL expected loss model, and the LOL model would have created significant financial disruption in the financial system. This is due to several factors:

1. Reliance on impairment models that recognized the long period of low loss levels preceding 2007 would have kept ALLL levels low until 2008, as credit metrics experienced in 2006-2007 would have been expected to, in the long-term, revert back to historical norms. In fact,

⁵ Default is a key concept in loss estimation outside the U.S., but it is rarely used within the U.S.

⁶ We understand the point that is being made; however, this wording is confusing. For example, “the possibility that a credit loss results” when applied to Treasury securities is difficult to understand, and “the possibility that no credit loss results” for loans is confusing because it seems that if no credit loss exists, impairment would not be recorded.

⁷ While GAAP does not have “expected value” within the conceptual framework, FASB Statement of Financial Concepts No. 7 *Using Cash Flow Information and Present Value in Accounting Measurements (CON7)* describes present value as a probability-weighted present value measurement, noting “The only objective of present value, when used in accounting measurements at initial recognition and fresh-start measurements, is to estimate fair value.”

⁸ Unless the cash flows over the expected life of a loan are estimated, the net balance cannot be considered to be a present value.

⁹ ABA notes that, while improving timely loss recognition is the primary objective of the impairment project, there is no significant implementation guidance provided within the ED in understanding and evaluating loss events or other kinds of credit deterioration.

¹⁰ As noted in previous ABA comment letters related to impairment, the banking regulators requested changes during the 1990s.

if the expected losses were based on pricing assumptions, we believe adjustment to appropriately higher loss expectations may have occurred later.¹¹ While it is likely that ALLL levels would have been higher during the years preceding the Crisis, it is also likely that the LOL model would have been considered insufficient.

2. In concert with the disconnect between long-term loss expectation and current experience, uncertainty would develop related to the impact that changes in credit metrics (delinquencies, credit ratings, loan to value ratios, etc.) have on bank capital. Overall deterioration that is “expected” would not necessarily result in increased credit losses. Further distrust of management’s expectations would likely have developed during the Crisis.
3. Long-term loss expectations within the LOL models would add to volatility in times of systemic distress. Once the long-term expectations change, the increase (as it pertains to longer periods) would have a compounded impact, increasing the procyclical nature of the industry.
4. Because of the cyclical nature of debt instrument performance (relatively long periods of very good performance, followed by short periods of very bad performance), historical loss averages, even those based on “through the cycle” data, are likely not to remotely represent the loss content within the portfolio. Losses are likely to be much greater than the average or much less than the average. Providing reasonable and supportable documentation to adjust from these averages will be challenging, due to the long-term (through the remaining life) nature of the allowance. ABA questions whether this information is useful.¹²

In addition to these problems, implementing such a change to the impairment model will virtually eliminate comparability between banks, as well as year-by-year information within a bank. Retroactive implementation, since the model is based on future expectations, would be justifiably viewed with suspicion. For analysts and other users, all historical analysis would likely be rendered useless for several years.

LOL Model is Costly to Implement

Bankers in the U.S. have never managed loans in an LOL fashion. Therefore, wholesale change to processes and to the maintenance of data will be required to estimate such an allowance. For example:

1. Origination dates are often not maintained on renewable loans (many commercial loans issued today are renewable¹³) or loans resulting from acquisition through business

¹¹ Changes in long-term investment return assumptions related to pension accounting are an example of how changes in expectations may not necessarily be considered timely.

¹² Historical averages are currently used in estimating the ALLL. However, such data is relatively short-term in nature and is easily back-testable on a timely basis. A further discussion on the reliability of data is included later in this letter.

¹³ Expected lives of most commercial renewable loans are far longer than the contractual lives. ABA notes that limiting the expected portfolio life to the contractual life could, in fact, alleviate a portion of the complexity of the

combinations. This is a concern because we believe portfolio LOL loss rates will often be based on probabilities over the expected life of the portfolio. If origination dates are not reliable,¹⁴ then loss rates based on the probability of default within X years become likewise unreliable.

2. Loss rates used in modeling “pass” loans and in criticized loans, revolving credit lines, as well as used in roll rate analysis, have traditionally been focused on a one to two year time horizons. Therefore, none of the current credit metrics used today will be useful. Totally new and untested systems must be created.
3. For certain products, timing of the loss (to determine exposure at default) and of recoveries are critical inputs that have not been integrated into bank systems in a manner to support LOL estimates.
4. Bankers in our working group that provide revolving credit lines have widely varying assumptions related to implementing CECL related to loan life and the allocation and application of interest, fees, charge-offs and recoveries to specific credit draws. Different assumptions not only will significantly impact the loss estimate, it also can greatly impact the operational processes required to support such estimates. As a result, it is questionable whether, without significantly more implementation guidance, there will be consistent application.

In addition to these problems, we believe most community banks do not have sufficient reliable data that would withstand audit scrutiny. For example, community banks in our impairment working group show loss percentages to be cyclical, with significant standard deviations from the vintage-based averages. As a result, ABA believes community banks will generally be required to acquire market data from third-party providers in order to be able to support their LOL expectations. Quantitatively supporting the extent of specific adjustments that will be needed from this data in order to apply to individual banks is a concern.

LOL Model Can Wreak Havoc with FASB’s Conceptual Framework

An “expected loss” impairment model does not necessarily create conceptual accounting problems. However, as we believe is generally understood by bankers and banking regulators, the CECL model is designed to recognize credit losses before the events that cause the losses actually occur. This directly contradicts the FASB’s Conceptual Framework:

- “Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.”

process. However, it would compromise FASB’s overall objectives of LOL impairment on a practical basis. Further, this simplification would also be undermined by current standards related to troubled debt restructurings (TDRs), which classify a significant portion of loan renewals as TDRs, thereby extending expected loan lives.

¹⁴ Since origination date has never been a key input in the allowance process, significant work would also be required to ensure the reliability of such dates, for internal control purposes, within the historical records of origination dates that do exist.

- “Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”¹⁵

We agree with those who point out that there is no other precedent in GAAP for this. While expectations of the future are common in other aspects of *measurement* (fair value estimates and amortization of deferred loan costs, for example¹⁶), we are not aware of instances in which such expectations are used in *recognition* of an asset (or in this case, a contra-asset) that is accounted for in a historical cost framework.¹⁷ It is as though a “fair value” concept is being applied to the historical cost framework.

Currently, forecasts in estimating the ALLL are routinely performed. However, these forecasts are performed in estimating whether losses that have occurred by the balance sheet will *emerge* (the bank will identify and confirm) in the future. In our discussions with investors, they realize that forecasts over the next year or two lose precision. We question whether requiring forecasts to be made of future loss events, without the anchor of the reporting date, will provide sufficient incremental value for the cost of turning the Conceptual Framework on its head.

This contradiction with the Conceptual Framework is what underlies the large “day 1 loss” that is recorded upon origination (whereby the loss anticipated several years in the future is recorded immediately, though the interest income is recorded over time). This contradiction creates the perverse result that loan growth causes losses and loan contraction accelerates profit growth. In other words, a positive banking event (the healthy borrower renews its business with the bank) causes a negative accounting result (a higher loss), resulting in a disincentive to follow the economics of the transactions, due to the capital strain.

¹⁵ Statement of Financial Accounting Concepts No. 6 *Elements of Financial Statements* (CON 6). Note that CON 6 explains that the term “probable” is not meant to be used in a specific accounting or technical sense, but “refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.”

¹⁶ While some may argue impairment may be a measurement issue, ABA believes neither fair value nor amortization of deferred loan costs are comparable to loan impairment measurement. Fair value is based on a premise of a hypothetical transaction entered into at the balance sheet date, while amortization refers to a rational method of income/cost recognition. These differences are precisely why financial statement users rejected the idea of marking loans to market in reaction to the 2010 exposure draft issued by FASB.

¹⁷ We are aware the FASB and the IASB are considering changes to the definition of “asset” that would eliminate the words “past events...” However, accrual accounting within FASB Concept Statement No. 8 Chapter 1, *The Objective of General Purpose Financial Reporting* speaks to “events and circumstances ...even if the resulting cash receipts...occur in a different period...” as though events must occur in order to reflect financial performance.

ATTACHMENT 2: THE U.S. BANKING INDUSTRY MODEL FOR IMPAIRMENT (BIM) AND LOSS EMERGENCE PERIODS

BIM addresses user concerns and requires incremental operational changes.

Within our response to the April 1, 2011 Supplemental Document issued by FASB and IASB, ABA endorsed the BIM and included a brief description of the model. We believe:

1. The BIM easily conforms to the FASB and IASB conceptual frameworks. Using the BIM as a standard could also help satisfy IASB members who believe that losses are never inherent in a loan at the time of origination.
2. Using the BIM as a standard will greatly assist financial statements users and preparers in their understanding of the credit loss management process while more directly tying changes in credit metrics to changes in the ALLL.
3. BIM is the only impairment model that will directly address cyclical trends that present long-term systemic risk, as well as provide the transparency needed to understand how management evaluates credit risk going forward.
4. The objectives of the BIM are the same as the CECL – to record all *relevant* loss content within the loan balance. Compared to the current incurred loss model, timelier loss recognition will result.¹⁸
5. Implementing the BIM will result in far less operational changes for U.S. banks than the CECL or the IASB model. BIM also allows for jurisdictional interpretation by regulators to implement and improve over time, as knowledge of credit behavior increases.

In short, the BIM can be described as follows:

1. The Core Component:
 - a. The objectives of the BIM core component are to estimate, with regard to loans that otherwise show no individual impairment, charge-offs that are foreseeable with reasonable confidence.
 - b. The “probable loss” notion is discontinued; instead, meaningful changes in the probability of loss and/or loss exposure should be reflected.¹⁹

¹⁸ ABA agrees with FASB in the belief that the main improvement needed to the current impairment model is that the “probable loss” requirement interferes with timely recognition of losses. However, we are aware of no significant concerns or discussions related to the measurement of losses.

¹⁹ The BIM intentionally does not advocate a “more likely than not” threshold for loss recognition, as it does not align with practical risk management practices. There are events that may not pass a “more likely than not” threshold, yet an allowance would be appropriate, due to the significant potential impact. A company considering closing the major factory in a local community is an example of this.

- c. Detailed guidance on loss events is provided, particularly for “forward-looking loss events and conditions” that indicate impairment at the balance sheet date.
2. The “Credit Risk Adjustment” (CRA) component is used to address cyclical and systemic exposure in a fully-disclosed manner. The CRA represents estimates for exposure that cannot currently be captured in credit metrics.
3. Credit risk disclosures are expanded to provide for comparability related to the ALLL process.

The BIM conforms to the FASB conceptual framework, thus requiring a smaller “Day 1 Loss” than the CECL.

The BIM “Core Component” aligns with the FASB conceptual framework, which recognizes impairment based on “past transactions and events.” However, contrary to the current incurred model, the BIM alleviates the requirements of the “probable loss” notion and adds significant guidance as to “loss events.”

During the FASB deliberations with the IASB, IASB members have expressed disagreement with the concept of large “day 1 losses” (which result from life of loan loss estimates recorded at origination). ABA agrees that future loss events should not be included in the impairment estimate.²⁰ With that in mind, the objective of the BIM is not to estimate future loss events, which is required in a LOL model. The objective of the BIM is to estimate the losses that are inherent in the portfolio at the balance sheet date. As a result, large day 1 losses are generally avoided; however, large day 1 losses are not *always* avoided. As a result of how long the assumed loss emergence period²¹ is for a specific portfolio under the BIM, it is possible that, depending on the perceived direction of the economy (or other current factors), portions of certain higher risk loan portfolios may be considered impaired at origination.

Therefore, ABA believes that guidance related to loss events is key, not only for the effective recognition of losses, but also for global convergence. With that in mind, we review (below) the concept of a “loss event.” Based on our discussions with bankers in some other countries and our observations of the IASB’s discussions on this, we strongly believe that disagreements on the definition of “loss event” are a key reason for the lack of agreement on an impairment model. Additionally, we are not aware of any agreements reached between the FASB and IASB on the use and definition of loss events. As noted later in this document, agreement on this is critical. Without agreement, we believe there will be no convergence.

²⁰ Although we believe future loss events should not be included, future events that confirm existing losses should.

²¹ The loss emergence period is the period between the time a loss event occurs and the time it is confirmed; and, in the U.S., confirmation is generally when the uncollectible amount is charged off. A fuller discussion of the loss emergence period is below.

The BIM utilizes and defines the critical component of impairment: “loss event”, and expands the “loss emergence period”.

Loss events

The definition of a “loss event” is the key factor in determining the timing of recognition of loss. When a loss event occurs, it must be provided for in the ALLL.

Loss events, appear to be defined as an earlier point in time under U.S. accounting practices than under International Financial Reporting Standards (IFRS). Under IFRS, the term “loss event” is defined within IAS 39. Briefly, IAS 39 defines the following as loss events:

- Financial difficulty of the issuer/obligor
- Breach of contract: default or delinquency
- Loan modification with concession lender would not otherwise consider
- Becoming probable of borrower bankruptcy/reorganization
- Disappearance of active market due to financial difficulties
- Data indicating a decrease in cash flows from a group of financial assets, though it cannot yet be identified with individual assets in the group, including:
 - Adverse changes in payment status of borrowers in the group
 - Relevant macroeconomic or industry conditions, including property prices, oil prices, etc.

In U.S. GAAP, there is generally no discussion of loss events as they relate to loans. However, within bank practices, as guided by banking agencies, the following are normally considered “loss events”:²²

- Borrower loses major source of income. For a consumer, it is normally his/her employment. For a commercial borrower, it is a major customer.
- Overall, financial results put repayment at risk, as evidenced in a commercial loan review.
- Property value deterioration, as evidenced when loan to value ratios exceed 100%.

Thus, U.S. practice would likely refer to IAS 39 “loss events” not as loss events, but as loss *identification* events, which are generally subsequent to loss events. It is indeed a challenge to estimate when a loss event has occurred in the U.S., but there is general agreement that the loss event happens prior to default. Thus, the foundation for defining when a loss is a loss under IFRS naturally leads to later loss recognition than in the U.S. This may also lead to the viewpoint that unimpaired loans need no allowance for losses. We believe this fundamental disagreement over “loss events” has been the key factor in the inability to reach international agreement on credit impairment.

²² *Allowance for Loan and Lease Losses – Comptrollers Handbook*, published by the Comptroller of the Currency is one example where “loss event” is defined. <http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/alll.pdf>

Loss emergence period

In the U.S., ALLL estimates for loans not individually identified as impaired are based on various methods, though the vast majority center on estimating a “loss emergence period.”²³ The loss emergence period starts at the time a loss event is assumed to have occurred, extends through the time of discovery²⁴ and workout, and ends at the point of confirmation, which is normally at charge-off.²⁵

In a portfolio of loans, loss events may have occurred without showing signs of impairment. Understandably, a bank is unable to specifically identify those events, and current GAAP helps with this dilemma. Loss events that have occurred but have not yet been identified are provided for in the “FAS 5 reserve” (now referred to as Accounting Standards Codification (ASC) 450-20).

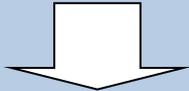
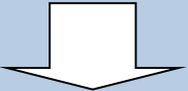
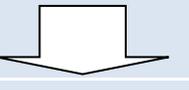
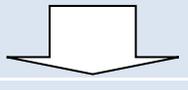
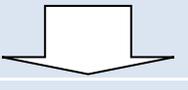
²³ Some banks specifically calculate a loss emergence period; other banks use a 12 month charge-off rate (with adjustments) that equates to the use of a similar emergence period.

²⁴ The time between the loss event and loss discovery will depend on the nature of the loan and borrower, loan terms and frequency of lender contact with the borrower. For example, loans that allow interest to be paid out of an interest reserve may delay the discovery of the loss. Likewise, borrowers may fall behind on their contractual payments on specific loans (credit cards, for example) before other loans. These factors may extend the loss emergence period. The loss emergence period can exceed two years in some portfolios.

²⁵ For consumer loans, U.S. banks are normally required to charge-off amounts that are delinquent no greater than 120 days for installment loans and 180 days for revolving accounts. Commercial loan charge-offs normally are based on case-by-case analysis, with the exception of collateral-dependent loans. Collateral dependent loan charge-offs are based on the fair value of the property.

ABA generally supports the IASB and FASB proposals to define “write off” as a direction write-down of the cost basis of an asset when there is no reasonable expectation of future recovery. Charge-off practice in the U.S. appears to apply a practical interpretation of the write off concept. ABA is aware of laws in certain countries that prevent the charge-off of loans until a specific point in the workout process. Because this may be unrelated to the accounting for financial reporting purposes, interpretations similar to those in the U.S. should be considered for application in those countries.

The loss emergence periods in the U.S. versus IFRS currently look like this:

		U.S. Practice	Events	
Loss Emergence Period	Incurred losses not individually identified (ASC 450-20/ FAS 5)	Loss Event 	<ul style="list-style-type: none"> • Job loss • Loss of major customer • Significant property value decline 	
	Individually identified impaired loans (ASC 310-10/ FAS 114)	Discovery Event 	<ul style="list-style-type: none"> • Default • Delinquency • Risk rating criticism 	IAS 39 Loss Event 
		Confirmation	<ul style="list-style-type: none"> • Charge-off 	Confirmation

U.S. bankers generally follow a guideline whereby the loss emergence period approximates 12 months, depending on the portfolio (certain portfolios require a period greater than 12 months), as it is assumed that a probable loss within that time period should become apparent in that time frame.²⁶ The ALLL estimate is based on the expected charge-offs on the loans in the portfolio over the loss emergence period.²⁷

Although the U.S. loss events are generally earlier than in IAS 39, there is room for improvement in definition loss events. For example, the U.S. definition may miss some situations where loss events may actually have occurred, but are masked for periods of time due to declines in underwriting standards, new products with contractual terms that delay full payments, or developing macroeconomic trends that, if continued, put collectability at risk. Reliance on these traditional loss event definitions may be slow to catch property value developments and other important macroeconomic trends that arguably cause credit problems. This, coupled with the discontinuation of the “probable loss” notion, means that the loss emergence period may need to increase.

²⁶ See *Allowance for Loan and Lease Losses – Comptrollers Handbook*, page 14.

²⁷ Generally, the loss emergence period is multiplied by an assumed yearly charge-off rate to estimate the loss rate for the ALLL. If the loss emergence period is estimated to be 18 months, for example, the yearly charge-off rate is multiplied by 1.5 to arrive at the allowance required. Certain adjustments are then normally applied to the rate to ensure the rates apply to the credit environment as of the balance sheet date (instead of the periods in which historical data was used to derive the charge-off rates).

BIM, loss events, and loss emergence period

Within the BIM, forward-looking loss events are events and conditions that (individually and in concert with other events) generally precede what has traditionally been viewed as a loss event. The events and conditions can be ***reasonably expected*** to cause those traditional loss events.

Some examples of these events and conditions include:

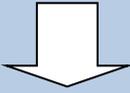
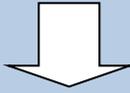
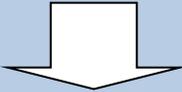
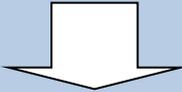
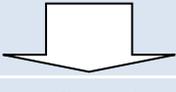
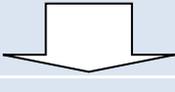
- Financial difficulty of, or cost reductions taken or *considered* by, an employer or major customer of an obligor or group of obligors. This includes the town factory that is considering closing or moving.
- Foreseen financial difficulty due to existing contractual payment spikes.
- *Progression* of the current macroeconomic cycle.
- Regulatory, legal, or competitive actions and conditions that have national, local, or industry-specific impact.
- Other macroeconomic or environmental conditions that may have an impact on a specific obligor or group of obligors.

In addressing economic conditions, continuing the direction of the macroeconomic cycle is considered “foreseeable”; attempting to determine the height and depth of economic cycles after the current cycle is not foreseeable.

We should emphasize that these foreseeable events and conditions are based on risk that is already in the portfolio at the reporting date. This is not an attempt to determine loss events in the future, but identification and confirmation of those events that have already occurred. Thus, deteriorating operating performance of a commercial borrower rated “pass” may be considered a loss event in light of an economy that has begun to slow or contract.

Deteriorating operating performance of a company typically results in credit deterioration. However, if operating performance deterioration is masked by a healthy economy (in other words, if the economy wasn’t doing so well, they would be struggling), the loss emergence period would be expected to increase. As the economy begins to slow, those companies will likely be the first and quickest to *exhibit* the credit deterioration that was already building.

With this in mind, the BIM loss emergence period diagram will look like this:

		BIM	Events
Loss Emergence Period	Incurred losses not individually identified (ASC 450-20/FAS 5)	Forward-looking loss events or conditions 	• Foreseeable conditions and events that confirm current impairment 
		Loss Event 	• Job loss • Loss of major customer • Significant property value decline 
	Individually identified impaired loans (ASC 310-10/FAS 114)	Discovery Event 	• Default • Delinquency • Risk rating criticism 
		Confirmation	• Charge-off

Thus, loss recognition would change, as noted in the following table:

Current GAAP Treatment	BIM Treatment
Losses recorded when LTVs <i>become</i> > or near 100%.	Losses recorded if LTVs <i>are reasonably expected to be</i> > 100%, based on continuation of macroeconomic trends and of contractual terms.
Losses recorded <i>when</i> (or shortly before) borrower is delinquent.	Losses recorded when analysis indicates borrower <i>may become delinquent</i> when payment spikes go into effect.
Losses recorded when factory closes or <i>announces</i> closing in a town.	Losses recorded when factory is <i>considering</i> closing.

Losses reflect rating *after financial results* of the local grocer are weak.

Losses reflect higher risk when ABC Company *announces the opening* of a Superstore across the street.

Along with the expansion of “forward looking loss events and conditions,” more disaggregation of credit risks is likely in order to match forward-looking loss events to more detailed parts of a portfolio. More important, however, loss emergence periods are likely to increase. While some bankers currently may be, in certain situations, already extending their emergence periods longer than 12 months, this will confirm that expectation and likely add time as emergence periods are analyzed under a new lens.²⁸

The concept of “forward-looking loss events” is needed, primarily because of the discontinuation of the “probable loss” notion, as well as the realization that economic cycles have a significant impact on the collectability of loans. Similarly, the BIM utilizes the economic cycle not only because it has an explicit significant impact on credit losses, but also because macroeconomic trends can mask weaknesses that standard metrics cannot overcome. Past credit cycles have seen extended periods of benign activity followed by rapid parallel upward shifts in credit loss estimates. The specific economic and credit conditions that lead to the negative credit shocks often accumulate over a number of years, but often are not readily apparent in the credit metrics commonly used to estimate the Base Component. This is why a Credit Risk Adjustment is needed.

The Credit Risk Adjustment (CRA) Component addresses user and regulator concerns

The CRA is a separate component of the ALLL that is primarily established to address the inherent limitations in a company’s credit forecasting process and the cyclical nature of macroeconomic conditions. Past credit cycles suggest that credit losses build even during benign credit environments and these losses later become transparent as the credit cycle deteriorates. Consideration of these factors, therefore, would likely cause the CRA to be highest during these benign credit environments, thus, ensuring that inherent credit losses are appropriately recognized even during such periods. Conversely, the CRA may not be as high during times of increasing loss rates, as the portfolio’s loss content is reflected or more apparent in current credit quality indicators and therefore would be more fully captured by the Base Component. Within the BIM, however, there is transparency for financial statement users: disclosure as to the amount of the CRA, what factors the CRA is meant to address, and management’s qualitative expectation of the progression of the cycle.

Contrary to aspects within the IASB model or the CECL, the CRA in the BIM is really the only idea that addresses the cyclical nature of the economy and its impact on loan impairment. The

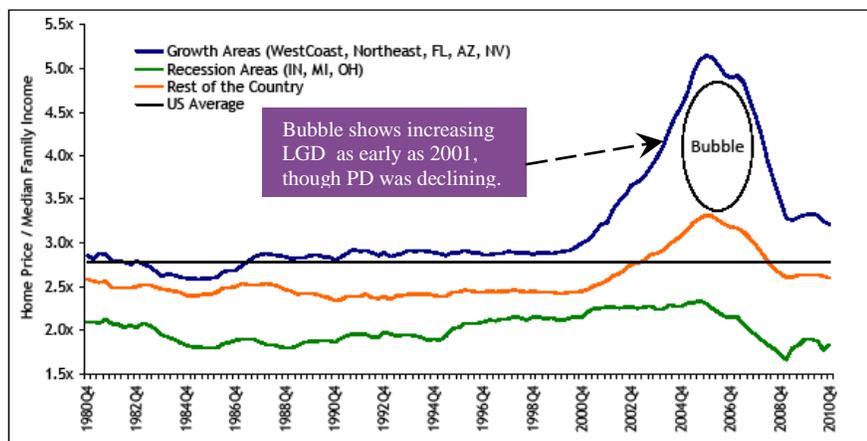
²⁸ Current practice in the U.S. includes consideration of various qualitative factors in estimating the ALLL, much of which may closely align with “forward-looking loss events.” The impact of codifying such an expectation in the U.S., therefore, will vary on a bank-by-bank basis.

CECL includes a concept of “credit risk adjustment” and “progression of the economic cycle.” However, we believe the IASB and CECL models do not adequately address the following:

1. Increase in risk during a “bubble” can be accompanied by a prolonged period of improving credit metrics related to probabilities of default. The chart below, related to home price affordability (Price to Income ratio), indicates that a significant bubble had developed by 2002. However, loss experience through 2005 improved. Without considering loss *exposure* in the impairment model, the new model is likely to suffer the same loss recognition problems as the current incurred model.
2. As economic expansion is typically accompanied by loosening underwriting standards, those standards often move *subliminally* (e.g. a risk rating of “3” now is not the same as a risk rating of “3” in 2009). Explicit declines in underwriting standards for certain products can be addressed through disaggregation of credit characteristics. However, subliminal shifts are much more difficult to detect (expanding the loss emergence period addresses a portion of the shift). Without a CRA, applying allowances to address subliminal declines will only result in “earnings management” claims, as adequate documentation will likely be scarce.
3. Increase in risk during a bubble can result from credit concentrations and can be regional and systemic. Accurately estimating the cycle’s impact on a portfolio-by-portfolio basis, as well as providing reasonable and supportable evidence for the impact, will be folly.

Because of the very judgmental nature of the CRA, the provision must be accompanied by significant disclosure that allows financial statement users to understand what management sees going forward. Unless this provision is segregated from the core component, users will not be able to envision the risks that management sees.

Home Price to Median Family Income – Economic Regions



- Home price bubbles clearly began in 2001...why did it go unnoticed by most?
- National average Home Price to Median Family Income has been 2.8x since 1980
- Most areas deflating significantly since peak

The CRA is intended to capture those losses that are inherent in the portfolio, but due to the nature of the credit cycle, will not become transparent until credit losses begin to materialize. During the course of a normal credit cycle, the counter-cyclical nature of the CRA will offset some, but not all of the volatility created by uncertainty in the timing and amount of credit losses. For example, no impairment methodology could have fully addressed the dramatic parallel shift in credit loss curves experienced from 2007 to 2009. In periods of extreme credit stress, a company may need to increase the Base Component as losses become observable, but may decide a CRA is also necessary if sufficient uncertainty remains regarding the absolute levels of expected credit losses. In this manner, the CRA addresses both criticisms – reserve adequacy and timing of credit loss recognition – that are being leveled at the existing accounting guidance.

When all is said and done, the CRA addresses one of the inherent weaknesses of the CECL: the requirement for “reasonable and supportable forecasts” to support the estimated allowance. ABA is concerned about the broad concept of *requiring* the to use of “historical data, adjusted for current conditions and reasonable and supportable forecasts,” as previously noted. Since underlying historical data is dispersed and significant adjustments will be normally applied to the historical averages to arrive at a loss expectation, determining how “reasonable and supportable” the adjustments will be is in serious question.

The phrase “management’s evaluation of the current point in the economic cycle” invites huge differences in “evaluation” that we believe could be considered “reasonable and supportable.” Absent further guidance, this evaluation may be required (by auditors, the PCAOB, the SEC, etc.) to be based on published economist papers. Business cycle turning points, the key aspects of reasonable and supportable forecasts, are one of the main sources of economic forecasting errors.²⁹ If professional economists have trouble with such forecasting, we believe broad-based forecasting performed by most banks will include similar inaccuracies. It is true that such forecasts would be performed within the BIM. However, those parts of the cycle that present the most significant exposure to error – turning points in the cycle – are largely addressed through the fully disclosed CRA.

Banks are sometimes criticized for “earnings management” through their ALLL estimates and we believe the forecast of the future can be the most volatile part of the estimate. With this in mind, it seems to us that investors will want to better understand the volatile impact this evaluation has on the ALLL.

²⁹ Congressional Budget Office, *CBO’s Economic Forecasting Record: 2013 Update*. This report also notes “Business cycle turning points often occur during periods of high uncertainty... Under such uncertain conditions, widely different outcomes can appear equally probable, making it difficult to gauge whether an economic downturn is imminent.”

ATTACHMENT 3: BIM AND COMMON CONCERNS

BIM and the “foreseeable future”

BIM can be thought of as a “foreseeable future” model of impairment. However, it is different from the “foreseeable future” concept introduced during the 2011 Supplementary Document (SD). In the SD, there was no differentiation between loss events and charge-offs. Further, U.S. banking regulatory representatives made public statements opining that the “foreseeable future” period should never change. As a result, ABA, while not rejecting the foreseeable future concept, requested more information on the model. At the same time, the BIM was being developed and introduced.

Under the BIM, the “foreseeable future,” is not an arbitrary period for estimating loss events in the future. Under the BIM, “foreseeable future” refers to the loss emergence period.

The loss emergence period is a length of time after the balance sheet date that is qualitatively and quantitatively determined based on the loan terms, anticipated borrower behavior, and workout process, in which losses in the portfolio are confirmed. Within the BIM, creditors are required to deliberately analyze whether the direction and continuation of economic conditions will uncover impairment in portions of the portfolio. This includes specific identification of loan product terms or geographic characteristics that may be especially at risk in such an environment.³⁰ As these risks are disaggregated, separate impairment analysis may be appropriate or the loss emergence period can be extended.³¹ In addition to the standard loss emergence period concept of the BIM, we believe this part of the BIM – the requirement to analyze and identify “forward looking loss events” (the special conditions that can be reasonably expected to cause a loss event) – makes the BIM a workable, expected loss impairment model.

While we acknowledge that the loss emergence period can contract in times of economic stress, there are qualitative reasons for this. The period of time between the loss event (say, the job loss) and default or foreclosure can decrease if borrowers have already exhausted other available funding or credit lines (in other words, there was already underlying financial difficulty among borrowers) or if declines in home prices have motivated the borrower to immediately accept foreclosure. Note that under the BIM, with guidance around forward-looking loss events, this contraction should not be as acute.

³⁰ Once housing prices began to decline, many subprime loans prior to the Financial Crisis would have been disaggregated and losses accrued for years before borrowers defaulted on their loans.

³¹ The loss emergence period can conceivably extend for several years. An example of this is a secular economic decline in a geographic location caused by the loss of a major employer. Longer term loans may warrant longer loss emergence periods outside a bank’s standard period for a specific product, as these losses are foreseeable. As common credit characteristics are disaggregated, loss emergence periods can be formed around the applicable loans or directly provisioned.

Second, contraction in the loss emergence period merely reflects a reality that sudden unexpected increases in loss frequency and severity (as would occur in a time of stress) have broken the modeled trends, causing “forward looking” factors to become less clear as to their expected impact. The same difficulties will lie with the CECL (except the CECL will take that same lack of clarity and require projections of losses much further into the future). With this in mind, we believe the concept of a variable “foreseeable future” should not prevent people from understanding that appropriate loss allowances will be recorded.³²

BIM captures all *relevant* losses in the portfolio

Both FASB staff and banking regulators have asked us the question: “What portion of expected life of loan losses do you not want to record?”

The BIM is designed to capture all *relevant* losses in the portfolio. Credit risk can be viewed in four ways:

1. Loss emergence period – The BIM includes a foreseeable loss emergence period. For existing loans, this period, qualitatively and quantitatively determined, represents confirmation of losses that have already occurred.
2. Increased risk of loss – Because of the continuation of macroeconomic trends and contractual terms, there is a foreseeable and meaningful increase in the risk of loss.³³ The amount of the loss may be unclear, but precision of an estimate is expected to improve over time. An example of this situation is a portfolio of performing residential mortgages with payment spikes two to four years in the future. If housing prices indicate that loan to value ratios may result in “underwater” status at the time of payment spikes if the trends continue, based on appropriate analysis of other credit characteristics of the loans in the portfolio, loss recognition would be appropriate.³⁴
3. Increased loss exposure – While probabilities of loss are not apparent, loss exposure can significantly increase. An example of this is because of the favorable macroeconomic trends, asset value bubbles may be developing, but fail to emerge for years. In this example, based on the increased loss exposure, the CRA would be an appropriate tool for loss recognition.

³² Over time, credit risk analysis systems may be refined so that foreseeable future time periods will increase. Additionally, banking regulators may have a big role in evaluating and determining such time periods.

³³ ABA intentionally avoids the term of probability of default, as this can be construed to apply to specific periods of time and to imply identification of loss activity.

³⁴ ABA emphasizes that this foreseeable risk of loss applies within the context of the forward-looking loss event that has occurred by the balance sheet date. Current U.S. practice recognizes losses based on these factors in certain instances. However, based on a specific forecast of future housing prices, losses are recognized sooner and the amount of losses may increase under the BIM as compared to the current impairment model, since the “probable” loss notion is removed. Within the BIM, there is no concept of “lifetime losses” or “one-year losses.”

4. Arbitrary losses – Outside the loss emergence period, if there are no foreseeable increases in loss probability or increases in loss exposure, BIM does not arbitrarily record a loss. In this case, neither the reliability of a bank’s estimate of loss probability nor the precision of its loss exposure is adequate.³⁵

Requiring estimates beyond the qualitatively determined loss emergence period, where there is neither a visible indication of increased probability of loss nor of increased loss exposure, is unreliable and should not be required for the ALLL.³⁶ Those credit losses that should be included in an expected loss model (and are included in the BIM) recognize those increased risks outside the loss emergence period.

BIM is not dependent on unreliable long-term data

Use of Vintage Data

Losses recorded under the BIM should address all relevant credit risks. Credit risks that are not relevant are those in which both the probability of loss and the loss exposure are not known to be meaningful. While there may be some portion of the loss curve that is not addressed, ABA questions whether that portion of the curve (the long-term tail) is sufficiently reliable to represent a legitimate “expectation.” Both of the questions posed above relate to losses in the long-term (whether they relate to loss events or to charge-offs), and are based on the misassumption that life of loan historical loss data reliably supports a reflection of credit risk at a specific point in time. The difference between the BIM and the ED on this point is that long-term loss data is used in the BIM as a tool to assist in the analysis of credit risks, and the ED makes long-term loss data the starting point for any estimate. While adjustments from these averages are warranted, based on a company’s “reasonable and supportable” assumptions of the future, tracking these assumptions to actual “basis point changes” will prove more than challenging.

Within the ED, a vintage by vintage analysis of charge-offs is used as an example of how an entity can implement the CECL.³⁷ While this example is helpful in understanding that a wide variety of methods may be used to estimate life of loan losses, it also ignores the cyclicity of credit cycles. In the real world, as can be seen by the graph below of year-by-year charge-offs, reliance on vintage-based loss patterns would not translate into early loss recognition. In fact, depending on the dataset used, we believe it can delay loss recognition.

³⁵ Per CON 8, relevance and faithful representation are the two fundamental qualitative characteristics in useful financial information. ABA believes that the unreliability of amounts beyond those related to increases in the risk of loss or of loss exposure would quickly make such estimates irrelevant, as they do not faithfully represent the economic phenomena.

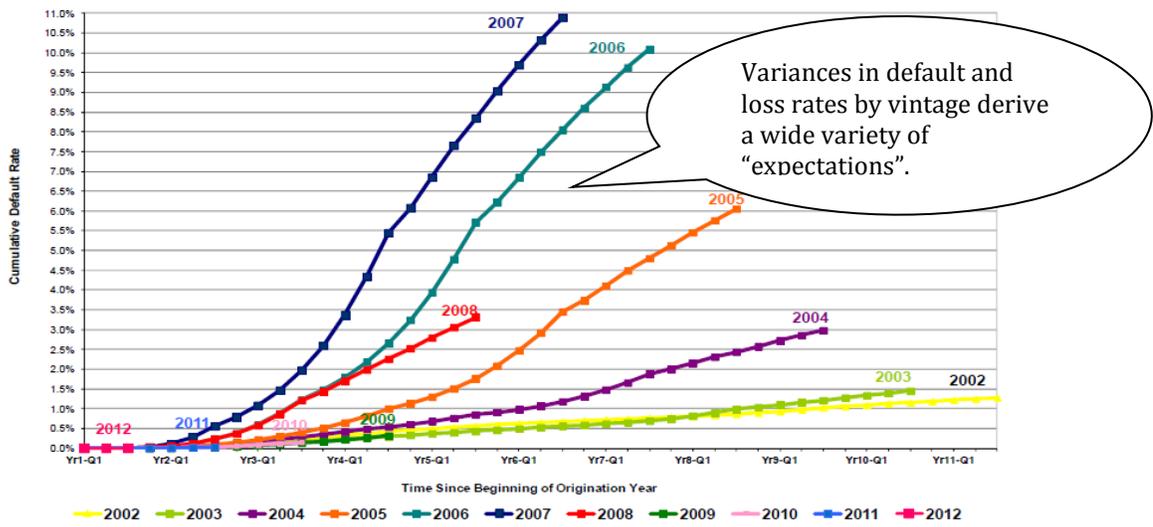
³⁶ Even if such losses were considered as reliable, ABA believes that these losses would effectively be offset by the applicable interest earned in the meantime, effectively offsetting the impact on net income and capital.

³⁷ During our discussions with certain banking agency personnel, vintage analysis has been suggested as a primary method to estimate expected losses.

A basic illustration of the variability of vintage analysis is illustrated here using Fannie Mae’s residential mortgage loss rates. There is no consistent pattern among vintages, and any pattern would be coincidence, as interest rate movement, which influences prepayment rates, makes virtually every year unique. To recommend that average rates be used by vintage year is basically telling banks to “make things up”.³⁸ Additionally, it is difficult to see how banks will be able to provide adequate documentation to support specific adjustments from the averages.

Fannie Mae Single-Family Cumulative Default Rates

Cumulative Default Rates of Single-Family Conventional Guaranty Book of Business by Origination Year



Source: Fannie Mae 3rd quarter 2012 Credit Supplement

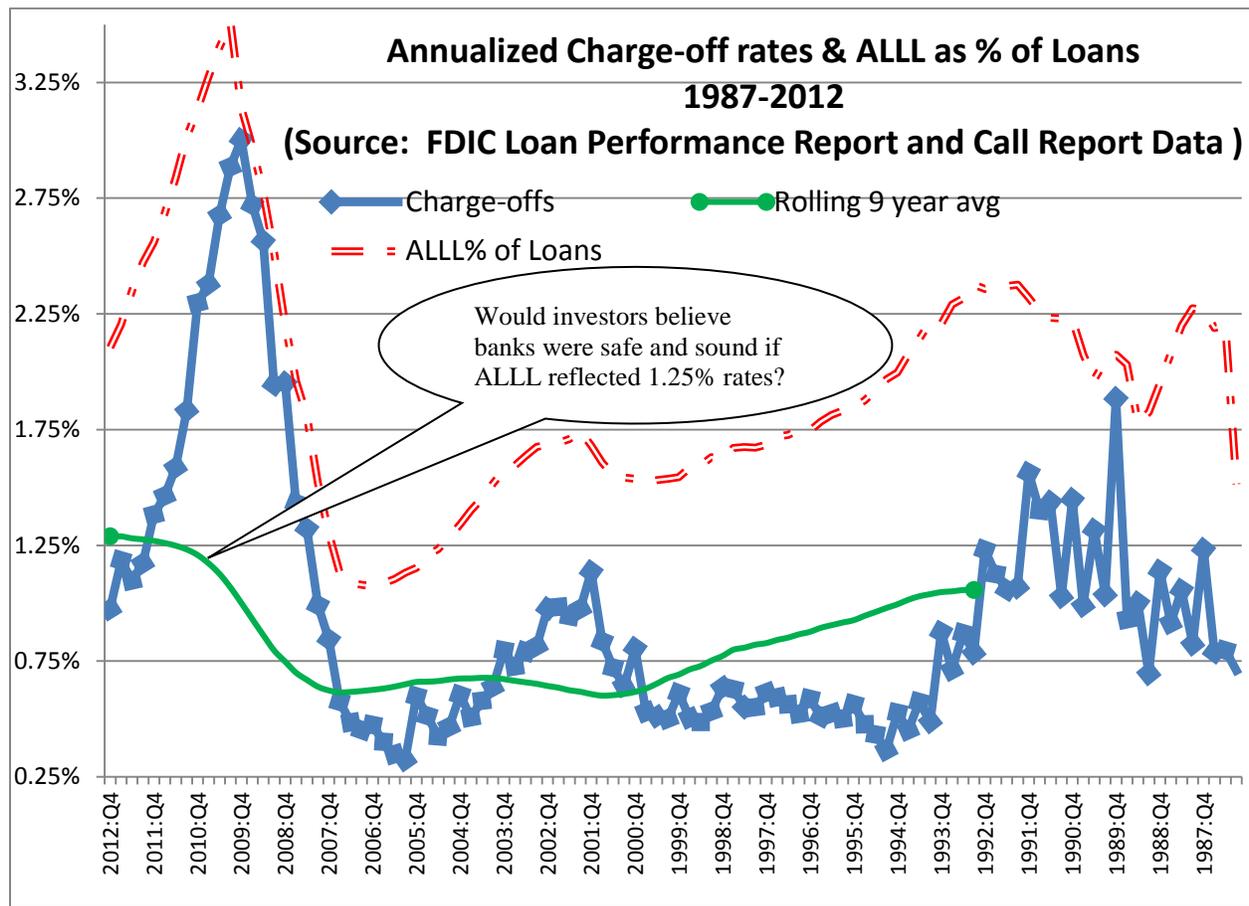
Use of Averages “Through the Cycle”

Average long-term loss rates that reflect an entire economic cycle have been mentioned by some as a basis for loss expectations. Similar to the concerns about vintage data, a big concern about these “through the cycle” averages is the significant adjustment that will likely need to be made and the lack of documentation to support the difference. With this in mind, average annualized charge-offs based on a 9 year average is a good starting point to examine how effective an average long-term loss rate would be, as a nine year period can generally capture a complete economic cycle. The chart below demonstrates that this “through the cycle” view bears little relation to the credit performance (demonstrated in the chart by quarterly annualized charge offs) in the contemporary economy. Although it is true that the losses will be confirmed over the very long-term, at a specific point in time we have no confidence in how much that loss will be. What

³⁸ ABA understands that an average loss rate may be appropriate for regulatory supervision purposes. However, such an approach also amounts to recording budgeted amounts. Either way, ABA strongly disagrees that such an approach should be used for financial reporting purposes.

we do know is that historical averages tend to either be significantly higher or significantly lower than actual credit risk at a point in time.³⁹

Our biggest concern, however, about the relevance of average long-term rates can be seen in 2007-11, with quarterly charge-offs reaching 3% of total loan balances while long-term expectations (rolling 9 year cycle) would dictate less than 1.25%. During that period, it is clear that banks and the users of their financial statements would not be comfortable with the use of long-term averages as a basis for loss expectations, the use of which implies that actual and long-term average are approximately the same when they are not.



It is true that historical loss rates are currently used for ALLL estimates. However, there is a big difference between relying on historical loss rates for life of loan loss assumptions and relying on annualized charge-off ratios for the current ALLL: results of back-testing⁴⁰ (and the

³⁹ The chart’s focus on net annualized charge-offs is not meant to reflect what the CECL allowance should be at a point in time, but over a long time period should reflect a general level of an expected loss rate.

⁴⁰ Back-testing refers to a bank’s testing, using historical data, of the accuracy of their predictive models. Through back-testing, a bank seeks to determine the performance of its models using various assumptions. Model risk is a key risk in the banking industry and will increase significantly under an LOL impairment model.

consequential adjustments to the model) become clear over the next year under the current model. The accuracy of assumptions within a life of loan model, however, may not be apparent for years. Since there is a natural inclination to rely on original assumptions until it is “probable” that expectations should be changed, this will lead to a less-timely adjustment and a more volatile loss estimate. Does this improve financial reporting?

With this in mind, ABA believes that *both* long-term data and short-term data should be considered in estimating the ALLL. Within the BIM, long-term data that span over several years, which is typically less reliable for specific allowances *at a point in time*, can be helpful in evaluating loan portfolio performance. It also can be used estimating the CRA. However, primary dependence on this data, which we believe is necessary under the CECL,⁴¹ establishes a foundation of inaccuracy.

⁴¹ Independent auditors are likely to require analyses of both short-term and long-term data. Analyses of long-term data will include review and back-testing of vintages and of average charge-off rates in order to 1) prove that the present value notion is adhered to, whereby an analysis of all cash flows not expected to be collected – over the entire contractual life – is performed (this would also include specific support that the longer-term “tails” of individual loss curves have been adequately provided for), and 2) set benchmarks for analytical review and from which loss rate adjustments can then be made.

ATTACHMENT 4: DETAILED COMMENTS ON OTHER IMPORTANT ASPECTS OF THE ED

Only small change to the current OTTI model is necessary for debt securities.

Debt securities should be excluded from the scope of the ED. The ED has very little mention of application to debt securities and no examples. Because of the complexity of its application to loans, to date, there has been very little discussion among the FASB, the industry, and regulators about how the standard would apply to debt securities. The current accounting for Other Than Temporary Impairment (OTTI), which was significantly improved with the 2009 amendments, provides the transparency needed for financial statement users to evaluate credit risk within these instruments.⁴² Thus, in lieu of major revisions to a standard that appears to be working well, we recommend that the current accounting for debt securities be retained with the only amendment being to immediately recognize improvements in credit quality through net income.^{43 44}

Bankers typically evaluate credit risk on debt securities on an individual basis. Although the CECL model can be applied to individual assets, it fundamentally addresses credit impairment related to pools of assets. Therefore, recording a life of loan loss estimate (or for that matter, any loss estimate) for unimpaired debt securities reflects neither how bankers view credit risk nor how the market views it.

ABA believes that such a requirement will burden most banks, due to the costs to support and audit such a life of loss estimate on many municipal securities. Community banks normally have a larger portion of their investment portfolio in local municipal securities than larger banks. The timeliness and quality of the financial information provided by the municipality is often poor⁴⁵ – making the default backstop for evaluating impairment being fair value. Further, many municipal securities are unique, and credit ratings (which bankers may be expected to use in their assessments), when available, are often inapplicable (for example, ratings may exist for the similar governmental units, though for different projects). The additional work that a bank will have to perform in order to comply with this standard will fall disproportionately on the community banks.

⁴² The 2009 amendments, in essence, split out OTTI between the credit loss and the non-credit loss. In addition to better transparency, since only the credit loss portion was included in Tier 1 capital, procyclicality (resulting from decreases to capital causing contraction of credit availability, which then caused further credit losses, and so on) was greatly reduced in the banking system.

⁴³ Under IFRS, reversals of impairment losses through earnings are allowed under certain circumstances for debt securities classified as held-to-maturity and available-for-sale.

⁴⁴ The FASB began discussion on such a project [Recoveries of Other-Than-Temporary Impairments (Reversals)] in 2009. It likely took a back seat as the FASB and IASB began considering inclusion of debt securities as part of this ED. We recommend that the “Reversals” project be brought back to life and finalized.

⁴⁵ Harrisburg, Pennsylvania’s failure to provide timely financial information, the subject of a recent enforcement action by the Securities and Exchange Commission, is an example of the lack of timeliness often experienced by municipal security investors. *The Wall Street Journal* cites an estimate that up to 20% of municipalities do not provide timely information after bond issuance.

Users of financial statements in the U.S. believe the 2009 amendments represent significant improvement and we are not aware of any requests for further change, aside from allowing reversals.⁴⁶ The existing standard allows analysts to compare the market view (fair value) to management’s view of the quality of the asset. We see no reason for a life of asset allowance. The only needed change to debt security impairment accounting is the opportunity to immediately recognize improvements in credit quality through net income. The ability to recognize credit improvements for both loans and debt securities exists within the CECL, and we believe that such a standard can easily exist within the current OTTI model for debt securities.

The proposed change to accounting for purchased credit-impaired (PCI) loans is a significant improvement to current standards. The same accounting should apply to all purchased loans, including those acquired in a business combination.

In the U.S., a big point of confusion that financial statement users experience related to bank financial statements is understanding the accounting for PCI loans. The operational requirements are tedious and the results can be very bewildering to explain and understand. Separate schedules are often provided to investors to reconcile how PCI accounting results square with “real results.” The ED dramatically improves upon this by requiring accounting that is aligned with real results. PCI loans are presented at par value (adjusted for non-credit discounts/premiums) along with the expected credit loss at purchase. ABA strongly supports this, and we anticipate that bank investors will, too.

With this in mind, ABA strongly urges the FASB to apply this accounting to all loan purchases – impaired assets or nonimpaired – including those acquired in business combinations. Overall, much of the improvement obtained through the proposed change to PCI accounting will be lost in the event of a merger or acquisition because of the general prohibition on recording an allowance for loan losses at the purchase date.⁴⁷ Such requirements have prevented banks from integrating loans into their existing systems, as separate accounting systems have been needed to measure impairment only from the time of acquisition for the specific assets. This two-tiered impairment model (one basing impairment roughly on the principal balance and the other one basing impairment on deterioration after acquisition) will continue to frustrate both bankers and investors. Such accounting should be consistent, no matter whether the company has purchased assets, originated assets or whether the company has undergone a merger or not.

⁴⁶ See ABA comment letter on Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b, Recognition and Presentation of Other-Than-Temporary Impairments, March 30, 2009: “Recoveries of OTTI should be reversed. OTTI should not be permanent if, in fact, the impairment is not permanent.”

⁴⁷ This prohibition generally went into effect in 2009 as a result of FASB Statement 141R *Business Combinations*. Outside a business combination, the problem of not recording an allowance at the time of acquisition for a non-impaired loan still exists, though the impact is insignificant for unseasoned loans, as such acquisitions are normally within the first few months after origination, when the fair value is close to cost. Liquidity-based fair value discounts on non-impaired loans still are high in 2013 and the lack of allowance, even on non-impaired loans, distorts the performance of this portion of the loan portfolio.

Part of the reason for the PCI proposed change in the ED is to allow banks to integrate these loans into their existing administrative systems. We recommend that the requirement to present PCI loans separately on the balance sheet be omitted. This inevitably requires ongoing management of the related pools of loans – in essence, it would continue to require maintenance and tracking of a closed pool.

The troubled debt restructuring (TDR) designation should be discontinued, with more informative disclosures proposed.

The TDR designation is a source of significant misunderstanding for investors, operational difficulty for bankers, and differing views among regulators, auditors and bankers. The emphasis on “market rates” (if the new rate is lower than the market rate, the modification is given TDR designation) masks the credit quality of many loans and the “once a TDR, always a TDR” accounting requirement is operationally onerous, especially after the borrower health has been sufficiently remediated. Clarifications provided by the FASB in 2011 only caused more loans to be designated as TDRs, as many standard renewals were previously excluded are now in the scope of the rules. As a result, the vast majority of loan modifications are designated TDRs and in many cases, it is operationally much more efficient to label all modifications TDRs than to perform the evaluations.

Bankers understand that providing a concession to a borrower is an indication that a loan is impaired, and loan modification information may be helpful to investors in evaluating credit quality. Such impairment, however, occurs whether the loan is modified or not. Therefore, the accounting for impairment should be independent of the TDR designation. ABA recommends the following:

- Discontinue the TDR designation and related disclosures
- Require disclosures related to all loan modifications by credit quality
- Require disclosures of all loans that have defaulted within a year of modification, renewal, or origination
- Include discussion of such granted loan modification concessions as indications of a loss discovery event within the impairment model (see separate discussion of the BIM)

ABA believes that these recommendations, if implemented, will greatly simplify the processing of loan modifications and give investors much more relevant and understandable information.

The nonaccrual principle is appropriate. However, the specificity around the alternative methods for recognizing interest income related to cash received while in nonaccrual status is not necessary.

The ED introduces the nonaccrual principle to GAAP for financial assets. While not currently defined within the GAAP codification, it is a principle prevalent in the U.S. banking industry and appropriate for inclusion in the ED. However, we are concerned that the required methods to apply cash received to interest income are not current practice and will be unnecessarily burdensome.

While the required methods (the cost recovery method is required when the collectability of both principal and interest are in question and the cash basis method is required when the collectability of only interest is in question, such as when the loan balance is supported by the collateral value) are generally used by banks in the situations noted in the ED (for example, when a loan’s collateral value supports the amortized cost, the cash basis method is required), this is not at all universal. In fact, many community banks use the cost recovery method exclusively of income recognition because they are unable to efficiently apply the cash basis method. With this in mind, we recommend that no specific method be required in applying the nonaccrual principle.

Roundtable discussions should be held with all types of constituents before finalizing the ED.

The required disclosures

Bankers are generally supportive of providing relevant information to their investors and regulators. Much of the proposed credit quality disclosure information appears to address the key credit risk concerns and is already within existing GAAP or is disclosed within Management’s Discussion and Analysis (MD&A) by publicly-held entities. With that in mind, however, specific disclosures present significant operational challenges and the incremental value of the disclosures is not clear. Discussions we have had with various investors indicate an overload of information, even within the existing credit quality disclosures. As a result, we believe the FASB should evaluate the ED’s disclosures in light of its Disclosure Framework project and hold roundtable discussions that include bankers, investors, and regulators with a focus on how much value the proposed disclosures will add. For example:

- The roll forward of loan balances will require significant operational work to produce these amounts. Such amounts are not monitored by the banks because they are not important to the management of credit risk. Individual activity will often be so large as to be irrelevant, as revolving arrangements, renewals and modifications will further mask any decipherable meaning. More important, it is unclear how much incremental value this information will provide. We understand that such information will allow analysts to see where loan growth is occurring (which could indicate a decline in underwriting standards) and whether loan repayments are slowing. However, similar conclusions can be made by comparing year-end balances and reviewing the already-existing schedules of loans by credit quality and delinquency. While the current process is not perfect, we do not see how much more decision-useful the roll forward schedule will be, especially when considering the system overhauls that will be required.
- Schedules of collateral values (particularly loan to value) can be useful for certain lending products. However, in most cases, unless a loan is impaired, bankers do not regularly obtain appraisals of collateral. As far we understand, the loan to value ratios that are updated (and often disclosed in MD&A) are often based on automated processes and broker price opinions that are not meant to be considered “fair value” in an audited, GAAP sense. Requiring loan

to value ratios, therefore, will often add to confusion and will be unnecessarily costly. The same can generally be said of FICO scores, as they are not regularly updated and the monitoring will be costly and possibly misleading. Akin to current efforts by the PCAOB to obtain documentation relating to controls over certain Level 2 fair value measurement inputs, ABA envisions significant costs for supporting disclosures of LTVs and FICO scores in an audit context.

- Disclosures as to forecasts of the future will present potential problems related to auditing and to confidentiality. Along with our general concern about the level of audit support required for long-term forecasts, ABA is worried that assumptions about the economic cycle could mean that auditors will want to link those assumptions to overall corporate action, such as pricing (for example, if the economy is expected to improve, pricing will reflect that). If this is the case, we believe this information could be proprietary and should not be disclosed. Therefore, the required level of detail for the qualitative disclosure may need to be lessened; however, this may result in a disclosure with little usefulness. As noted in our discussion related to the BIM, we support qualitative disclosure related to forecasts of the future (in the context that it confirms current loss events). However, general agreement needs to be reached as to the level of such disclosure and to the level of auditing required.

The required accounting

As mentioned earlier in this letter, impairment accounting is a key component of bank accounting. Because of the importance of impairment accounting, as well as the level of complexity involved in the ED, it is critical that the various constituents (users, preparers, banking regulators, SEC, and PCAOB) have the same understanding about the standard. Interpretation offshoots could wreak havoc for any of those constituents, and could be very costly.

As a result of these concerns, ABA believes that these issues need to be addressed in face-to-face discussions that include all the aforementioned constituents. We believe these discussions can address the geography as to where such disclosures are appropriate within the complete reporting packages of public and private companies, how much detail is necessary, as well as what auditing procedures and supporting documentation are necessary. Without knowing this, it will be difficult to assess the costs vs. benefits of the ED.

At least four years will be required to transition to the CECL, though only two years for the BIM.⁴⁸

Because of the operational complexity of the CECL, bankers will be required to capture data they have never captured. The current accounting for business combinations and loan

⁴⁸ These time frames are difficult to project, because the unknowns are what the banking regulators and SEC will expect, what the auditors will expect, whether users will find the standard to be useful, and whether the PCAOB creates new rules relating to the final standard. The roundtable discussions should focus on the interplay among these constituents' needs.

acquisitions has further limited the amount of information available in some portfolios. With that in mind, bankers have estimated that approximately five years will be required to implement the CECL.

While medium and large banks may be able to accumulate sizable amounts of data that would provide a sufficient basis for modeling under the CECL, it is questionable whether smaller banks will be able to do so, as yearly loss patterns may show very large and unpredictable variations because of the lower volumes. Smaller banks may be required to purchase market data and expectations from third-party vendors. This may decrease the time it will take to implement; however, it may also decrease the applicability of it to the banks' portfolios.

Contrasting this time frame to the BIM, bankers in the U.S. largely have the core systems already in place to implement the BIM, approximately two years is needed for transition. The time needed is to better integrate loss emergence periods into their credit quality review, to change systems required for many of the proposed disclosures, and to allow for more efficient disaggregation of sub-portfolios when unique credit risks are identified.

As noted above, under either model, the loan balance roll forward disclosures will require a significant amount of time to implement.

Efforts to agree on a high-quality, global impairment standard should continue.

Although the FASB and IASB have introduced separate impairment models, we continue to encourage both boards to arrive at one impairment model. That said, in order to be considered “high quality”, the model must abide by a number of general principles. But a high quality standard also must be supplemented by constant support of bankers, regulators, auditors, and investors. The following are several concepts that ABA feels are critical for a high-quality standard:

- Compliance with the FASB and IASB conceptual frameworks must be maintained.
- There must be world-wide agreement as to how the terms “impairment”, “loss”, “loss events”, “defaults”, “charge-offs/write-offs”, and “concessions” are defined and understood. There must be a standard that can be applied equally by institutions of any size and in any country.
- There must be a consistent link between credit metrics and loss provisions.
- There must be a consistent link between foreseeable risks and loss provisions.
- Improvement to current U.S. practice will consider the subliminal impacts of the economic cycle, as well as systemic risks, including those resulting from credit concentrations.
- There must be an understanding by regulators, investors, and auditors as to the high level of judgment required on impairment as well as a generally accepted understanding of what level of documentation is needed to be considered reasonable and supportable.

- There must be constant efforts by bankers and regulators to improve their processes, including sharing information related to foreseen risks and to understanding the linkages between the economic cycle, loss events, and loss discovery.
- There must be a general understanding as to the level of supporting documentation required for audit purposes. This is especially true for the level of disclosure about future expectations that are in the ED.
- Though there are expected to be differences in practice among banks, disclosures must be sufficiently robust for a financial statement user to have a general understanding of the specific practices of the institution.

As we have observed the discussions between FASB and IASB related to impairment, we believe that there has not been substantive discussion about several of these concepts, and it is questionable as to whether/how either the IASB ED or the FASB ED will arrive at a high quality standard. In order to achieve a high quality standard, the above concerns need to be addressed and discussed by the various constituencies.

ATTACHMENT 5: ANSWERS TO SPECIFIC QUESTIONS RAISED IN THE EXPOSURE DRAFT

Question for All Respondents

Scope

Question 1: Do you agree with the scope of financial assets that are included in this proposed Update? If not, which other financial assets do you believe should be included or excluded? Why?

ABA Response: No. As explained in our comment letter, impairment for debt securities should not be included within the scope of the exposure draft (ED).

The ED has very little mention of application to debt securities and no examples in the implementation guidance. The current model for Other Than Temporary Impairment (OTTI), which includes the 2009 amendments, provides the transparency needed for financial statement users to evaluate credit risk for these instruments, and it should be retained. Bankers typically evaluate credit risk on debt securities on an individual basis, whereas, the CECL model, while it can be applied to individual assets, fundamentally addresses credit impairment related to pools of assets. Therefore, recording a life of loan loss estimate (or for that matter, any loss estimate) for unimpaired debt securities reflects neither how bankers view credit risk nor how the market views it.

ABA believes that such a requirement will unintentionally burden community bankers, which tend to have larger portion of their investment portfolios in local municipal securities, due to the costs to support and audit a life of loss estimate on many municipal securities. Historically, the timeliness and quality of the financial information provided by the municipality is often poor – fair value is often a backstop used to efficiently determine possible impairment. Further, many municipal securities are unique, meaning that credit ratings (that may be expected to assist bankers in their assessment), when available, are often inapplicable (for example, ratings may exist for the similar governmental units, though for different projects). The additional work that a bank will have to perform in order to comply with this standard will fall disproportionately on the community banks.

Users of financial statements in the U.S. believe the 2009 amendments represent significant improvement and we are not aware of any requests for further change. The existing standard allows analysts to compare the market view (fair value) to management's view of the quality of the asset. We see no reason for a life of asset allowance.

The only needed change to debt security impairment accounting is the opportunity to immediately recognize improvements in credit quality through net income. This exists within the CECL, and we believe that such a standard can easily exist within the current OTTI model.

Recognition and Measurement

Questions for Users

Question 2: The proposed amendments would remove the initial recognition threshold that currently exists in U.S. GAAP and, instead, view credit losses as an issue of “measurement” as opposed to an issue of “recognition” because the credit losses relate to cash flows that are already recognized on the balance sheet. Do you believe that removing the initial recognition threshold that currently exists in U.S. GAAP so that credit losses are recognized earlier provides more decision-useful information?

ABA Response: Bank investors favor earlier recognition of losses than the current incurred loss model, whereby losses must be probable before being recognized. However, the economics of the lending business should also be reflected. In our discussions with investors, there has been hesitation when asked whether losses several years in the future should be reflected at origination, though interest income earned over the term of the asset will more than make up for a loss recorded at origination.

Question 3: As a result of the proposed amendments, the net amortized cost on the balance sheet (that is, net of the allowance for expected credit losses) would reflect the present value of future cash flows expected to be collected, discounted at the effective interest rate. Do you agree that the net amortized cost (which reflects the present value of cash flows expected to be collected) results in more decision-useful information than currently exists under U.S. GAAP?

ABA Response: Bank investors have told ABA that changes in the general probabilities of loss and of loss exposures should be reflected in the allowance for loan and lease losses (ALLL). This is not meant to be a strict mathematical exercise. However, where meaningful risk and exposure change, it should be reflected in the ALLL. Generally, as amortized cost generally approximates unpaid principal balance, both bank investors and bankers view losses in terms of principal that will not be collected rather than in a present value concept. While present value sounds appropriate, bankers and investors are more concerned with how much of the recorded balance will be collected or lost.

Question 4: The Board has twice considered credit loss models that would permit an entity not to recognize certain expected credit losses. In the January 2011 Supplementary Document, the Board considered a model that would permit an entity not to recognize some credit losses expected to occur beyond the foreseeable future. In the recent discussions on the three-bucket impairment model, the Board considered a model that would permit an entity only to recognize lifetime credit losses for loss events expected to occur within a 12-month horizon. Instead, the proposed amendments would require that at each reporting date an entity recognize an allowance for all expected credit losses. Do you believe that recognizing all expected credit losses provides more decision-useful information than recognizing only some of the expected credit losses? If not, how would you determine which expected credit losses should not be recognized (for example, 12 months or similar foreseeable future horizon, initial recognition threshold, and so forth)?

ABA Response: We do not support recognizing losses beyond the foreseeable future. Bank investors have told us that when there is significant credit risk foreseen, it should be addressed. They also realize projections of charge-offs more than a year in the future will be less reliable. There is no interest in limiting losses when they are foreseeable.

Question 5: The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial assets' remaining contractual cash flows. Do you believe that expected credit losses based on this information provide decision-useful information?

ABA Response: Yes; however, those estimates should not be beyond the foreseeable future. Bank investors realize projections of charge-offs more than a year in the future will be less reliable, but support using many different sources, including forecasts of the future, to be included in the estimate.

Question 6: For purchased credit-impaired financial assets, the proposed amendments would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be amortized into and recognized as interest income over the life of the asset. To achieve this result, upon acquisition the initial estimate of expected credit losses would be recognized as an adjustment that increases the cost basis of the asset. Apart from this requirement, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired assets and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you believe that using the same approach to recognize changes in the credit impairment allowance for purchased credit-impaired assets and non-purchased-credit-impaired assets provides decision-useful information? Do you believe that this is an improvement from the current model used for purchased credit-impaired assets?

ABA Response: PCI accounting has been problematic since inception. It is complicated and difficult to understand. ABA has never supported PCI accounting, and we welcome this change. Additionally, bank investors have told us that this proposed change is the issue that, by far, provides the most improvement compared to the current accounting.

Question 7: As a practical expedient, the proposed amendments would allow an entity not to recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost amount of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. The proposed amendments would require an entity to disclose the amortized cost basis of assets that apply this practical expedient each period. Do you believe that the practical

expedient for some financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income is reasonable? Why or why not?

ABA Response: We believe the Other Than Temporary Impairment model for debt securities is working, is well understood, and should be retained. Additionally, bank investors, as noted in the response to question 1, are generally satisfied with the current OTTI model for debt securities. No change is needed; therefore, the practical expedient is unnecessary. Practically speaking, the practical expedient will be used rarely due to the expected rise in interest rates in the future and the impact of those increases in the fair values of debt instruments.

Question 8: The proposed amendments would require that an entity place a financial asset on nonaccrual status when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. In such circumstances, the entity would be required to apply either the cost-recovery method or the cash-basis method, as described in paragraph 825-15-25-10. Do you believe that this approach provides decision-useful information?

ABA Response: “Nonaccrual” is a highly used and important concept in the banking industry and we support its inclusion within GAAP. However, , we believe it may, in certain circumstances, conflict with the present value notion of the allowance for loan and lease losses, and appropriate coordination will be required in the event the present value notion is required for GAAP.

If the decision is made to require the nonaccrual concept for GAAP, we believe industry practice should simply be described and included in GAAP, as it is well understood and it functions properly, and there is no need for change. However, the specificity around the alternative methods for recognizing interest income related to cash received while in nonaccrual status is not necessary. Bank investors are generally satisfied with current nonaccrual practice.

Questions for Preparers and Auditors

Question 9: The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial assets’ remaining contractual cash flows. Do you foresee any significant operability or auditing concerns or constraints in basing the estimate of expected credit losses on such information?

ABA Response: Bankers in the U.S. have never looked at the ALLL in a life of loan fashion. Therefore, wholesale change to processes and to the maintenance of data will be required to estimate such an allowance. For example,

1. Origination dates are often not maintained on renewable loans (many commercial loans issued today are renewable) or loans subject to acquisition through business combinations. This is a concern because we believe portfolio LOL loss rates will often be based on

probabilities over the expected life of the portfolio. If origination dates are not reliable, then loss rates based on the probability of default within X years become likewise unreliable.

2. Loss rates used in modeling “pass” loans and in criticized loans, revolving credit lines, as well as roll rate analyses, have traditionally been focused on a one to two year time horizons. Because the ED focuses on life of loan, none of the current credit metrics used today will be useful. Totally new and untested systems must be created.
3. For certain products, timing of the loss (to determine exposure at default) and of recoveries are critical inputs that do not currently exist in a manner to support LOL estimates.

In addition to these problems, we believe most community banks do not have sufficient reliable data that would withstand audit scrutiny. For example, community banks in our impairment working group show loss percentages to be cyclical, with significant standard deviations from the vintage-based averages. As a result, ABA believes community banks will generally be required to acquire market data from third-party providers in order to be able to support their LOL expectations. This is of concern, both from a cost perspective and from a reliability perspective.

There is general concern about the level of audit support required for long-term forecasts. ABA is worried that assumptions about the economic cycle may need to link to overall corporate action, such as pricing (if the economy is expected to improve, pricing will reflect that). If this is the case, we believe this information could be proprietary. General agreement needs to be reached as to the nature and level of documentation that will qualify as “reasonable and supportable” and to the level of auditing required.

Question 10: The Board expects that many entities initially will base their estimates on historical loss data for particular types of assets and then will update that historical data to reflect current conditions and reasonable and supportable forecasts of the future. Do entities currently have access to historical loss data and to data to update that historical information to reflect current conditions and reasonable and supportable forecasts of the future? If so, how would this data be utilized in implementing the proposed amendments? If not, is another form of data currently available that may allow the entity to achieve the objective of the proposed amendments until it has access to historical loss data or to specific data that reflects current conditions and reasonable and supportable forecasts?

ABA Response: See our answer to question 8. Further, we believe that, due to the cyclicity of credit cycles, the historical averages will have such wide standard deviations that the averages will be of no practical use. Adjustments to such averages will be difficult, if not impossible, to quantitatively support.

Question 11: The proposed amendments would require that an estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results. This proposal would prohibit an entity from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode). As described in the

Implementation Guidance and Illustrations Section of Subtopic 825-15, the Board believes that many commonly used methods already implicitly satisfy this requirement. Do you foresee any significant operability or auditing concerns or constraints in having the estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results?

ABA Response: ABA foresees practical problems when assuming there is possibility that a credit loss results. For U.S. government securities, which have never had default, a loss must be assumed. This does not make sense. Further, when cash collateral is maintained that sufficiently supports the loan balance, the same issue occurs. Guidance should indicate that the possibility of loss must be considered, though it may be zero probability.

Question 12: The proposed amendments would require that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. Methods implicitly reflect the time value of money by developing loss statistics on the basis of the ratio of the amortized cost amount written off because of credit loss and the amortized cost basis of the asset and by applying the loss statistic to the amortized cost balance as of the reporting date to estimate the portion of the recorded amortized cost basis that is not expected to be recovered because of credit loss. Such methods may include loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors. Do you foresee any significant operability or auditing concerns or constraints with the proposal that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly? If time value of money should not be contemplated, how would such an approach reconcile with the objective of the amortized cost framework?

ABA Response: The life of loan loss concept necessarily introduces many operational problems, since loss data is not managed or maintained this way. For example, some products require explicit present value-based estimates to determine exposure at default. ABA recommends that the FASB drop any reference to present value. The Banking Industry Model for Impairment addresses the concerns of investors and regulators without requiring present value analysis for nonimpaired loans.

Question 13: For purchased credit-impaired financial assets, the proposed amendments would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be recognized as interest income. Apart from this proposal, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for expected credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired assets and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you foresee any significant operability or auditing concerns or constraints in determining the discount embedded in the purchase price that is attributable to credit at the date of acquisition?

ABA Response: Operationally, this makes the process much easier. This is a significant improvement, but it should also apply to purchased non-impaired loans. There should be an allowance set up at acquisition.

Question 14: As a practical expedient, the proposed amendments would allow an entity to not recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. Do you foresee any significant operability or auditing concerns or constraints in determining whether an entity has met the criteria to apply the practical expedient or in applying it?

ABA Response: See response to question 1 above.

Question 15: The proposed amendments would require that an entity place a financial asset on nonaccrual status when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. In such circumstances, the entity would be required to apply either the cost-recovery method or the cash-basis method, as described in paragraph 825-15-25-10. Do you believe that this proposal will change current practice? Do you foresee any significant operability or auditing concerns with this proposed amendment?

ABA Response: ABA is concerned that the required methods to apply cash received to interest income are unnecessarily burdensome. While the methods (the cost recovery method and the cash basis method) are generally used by banks in the situations noted in the ED (for example, when a loan's collateral value supports the amortized cost, the cash basis method is required), this is not at all universal. In fact, many community banks with collateral dependent assets are using the cost recovery method of income recognition because they are unable to efficiently apply the cash basis method. With this in mind, we recommend that no method be required in applying the nonaccrual principle.

Questions for All Respondents

Question 16: Under existing U.S. GAAP, the accounting by a creditor for a modification to an existing debt instrument depends on whether the modification qualifies as a troubled debt restructuring. As described in paragraphs BC45–BC47 of the basis for conclusions, the Board continues to believe that the economic concession granted by a creditor in a troubled debt restructuring reflects the creditor's effort to maximize its recovery of the original contractual cash flows in a debt instrument. As a result, unlike certain other modifications that do not qualify as troubled debt restructurings, the Board views the modified debt instrument that follows a troubled debt restructuring as a continuation of the original debt instrument. Do you believe that the distinction between troubled debt restructurings and nontroubled debt restructurings continues to be relevant? Why or why not?

ABA Response: The TDR designation is a source of significant misunderstanding for investors and of operational difficulty for bankers. Further, determining what is and what is not a TDR is

a significant source of disagreement between banks and their regulators. Talks with investors indicate a broad misunderstanding. The emphasis on “market rates” (if the new rate is lower than the market rate, the modification is given TDR designation) masks the credit quality of many loans and the “once a TDR, always a TDR” accounting requirement is illogical and operationally onerous, especially after the borrower’s health has been sufficiently remediated. Clarifications provided by the FASB in 2011 only caused more loans to be designated as TDRs, as many standard renewals that were not included have now found to be in scope. As a result, the vast majority of loan modifications are designated as TDRs, and in many cases it would be operationally much more efficient to label all modifications TDRs than to perform the evaluations. Thus, the current accounting is not informative.

Bankers understand that providing a concession to a borrower is an indication that a loan is impaired, and loan modification information may be helpful to investors in evaluating credit quality. Such impairment, however, occurs whether the loan is modified or not. Therefore, the accounting for impairment should be independent of the TDR designation. Therefore, ABA recommends the following:

- Discontinue the TDR designation and related disclosures
- Require disclosures related to all loan modifications by credit quality
- Require disclosures of all loans that have defaulted within a year of modification, renewal, or origination
- Include discussion of such granted loan modification concessions as indications of a loss discovery event within the impairment model (see separate discussion of the Banking Industry Model)

ABA believes that these recommendations, if implemented, will greatly simplify the processing of loan modifications and give investors much more relevant and understandable information.

Disclosures

Questions for Users

Question 17: Do you believe the disclosure proposals in this proposed Update would provide decision-useful information? If not, what disclosures do you believe should (or should not) be required and why?

ABA Response: Bank investors believe the proposed disclosures can generally be useful, though they do not appear to care whether such information is audited, and they complain of information overload.

Note that the roll forward information, in order to balance, should also include changes in amortized cost due to amortization and/or accretion. Other disposals can occur other than from sale or repayment and other acquisitions can occur for purposes other than purchase or origination. Therefore, FASB should consider these circumstances, in light of comparability, when finalizing a standard.

Questions for Preparers and Auditors

Question 18: Do you foresee any significant operability or auditing concerns or constraints in complying with the disclosure proposals in the proposed Update?

ABA Response: Some of the disclosures present significant operational challenges and the incremental value of the disclosures is not clear. Discussions we have had with various investors indicate an overload of information, even within the existing credit quality disclosures. As a result, we believe FASB should evaluate the proposed disclosures in light of its Disclosure Framework project and after holding roundtable discussions that include bankers, investors, and regulators as to how much value the proposed disclosures will add. For example:

- The roll forward of loan balances will require significant operational work to produce. Such amounts are not monitored by banks because they are not important to the management of credit risk. It is unclear how much incremental value the roll forward information will provide. Individual activity will often be so large as to be irrelevant, as revolving arrangements, renewals and modifications will likely mask any decipherable meaning. We understand that such information will allow analysts to see where loan growth is occurring (which could indicate a decline in underwriting standards) and whether loan repayments are slowing. However, similar conclusions can be made by comparing year-end balances and reviewing the already-existing schedules of loans by credit quality and delinquency. While the current process is not perfect, we do not see how much more decision-useful the roll forward schedule will be, making it difficult to justify the systems overhauls that will be required.
- Schedules of collateral values (particularly loan to value) could be useful for certain lending products. However, in most cases, unless a loan is impaired, bankers do not regularly obtain appraisals of collateral. The loan to value ratios that are updated (and often disclosed in MD&A) are often based on automated processes and broker price opinions that are not meant to be considered “fair value” in an audited, GAAP sense. Therefore, requiring loan to value ratios will likely be both confusing and unnecessarily costly. The same can generally be said of FICO scores, as they are not regularly updated, and the monitoring will be costly and possibly misleading. Akin to current efforts by the PCAOB to obtain documentation relating to controls over certain Level 2 fair value measurement inputs, ABA envisions significant costs for supporting disclosures of LTVs and FICO scores in an audit context.
- Disclosures as to forecasts of the future will present potential problems related to auditing and to confidentiality. Along with our general concern about the level of audit support required for long-term forecasts, ABA is worried that assumptions about the economic cycle could mean that auditors will want to link those assumptions to overall corporate action, such as pricing (for example, if the economy is expected to improve, pricing will reflect that). This information could be proprietary and should not be disclosed. Therefore, the required level of detail for the qualitative disclosure may need to be lessened; however, this may result

in a disclosure with little usefulness. As noted in our discussion related to the BIM, we support qualitative disclosure related to forecasts of the future (in the context that it confirms current loss events). However, general agreement needs to be reached as to the level of such disclosure and to the level of auditing required.

As a result of these concerns, ABA believes that these issues need to be addressed in face-to-face discussions that include all the aforementioned constituents. We believe these discussions can address the geography as to where such disclosures are appropriate within the complete reporting packages of public and private companies, how much detail is necessary, and what auditing procedures and supporting documentation are necessary. Without knowing this, it will be difficult to assess the costs vs. benefits of the ED.

Implementation Guidance and Illustrations

Questions for All Respondents

Question 19: Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient? If not, what additional guidance or examples are needed?

ABA Response: Much of the guidance is confusing. Some of the implementation guidance refers to definitions of default, and it unnecessarily attempts to prove that various impairment models consider “both the possibility that a credit loss results and the possibility that no credit loss results” and that they “implicitly reflect the time value of money.” We believe this detracts from the basic question of “given what you know now, how much do you think you will collect?”

We also believe the guidance related to vintage analysis is illogical and unreasonable, due to the cyclicity of the credit cycle. If the CECL is issued as is, guidance is needed in determining the validity of models used. This will be an important issue.

The credit risk adjustment, as described in the ED, also makes it sound like no other loss adjustment factors are applied to an estimate. More guidance will be required if the CECL is issued as is.

Transition and Effective Date

Questions for All Respondents

Question 20: Do you agree with the transition provision in this proposed Update? If not, why?

ABA Response: The cumulative effect adjustment appears reasonable, as a retrospective adjustment would lack credibility related to previous years in the reporting period.

Question 21: Do you agree that early adoption should not be permitted? If not, why?

ABA Response: ABA sees no reason to disallow early adoption.

Question 22: Do you believe that the effective date should be the same for a public entity as it is for a nonpublic entity? If not, why?

ABA Response: We believe most banks, no matter the size or ownership structure, will require 4 years to implement the CECL model, due to the historical information and systems changes that will be required: custodians require approximately 3 years merely for the operational capability to process the new requirements. An additional year is likely needed to ensure that adequate historical data is maintained. Since there are significant changes proposed, not only are internal reports needed for bankers to use analytically and for financial reporting, new reports must be designed and prepared by custodians to satisfy their individual customer needs.

Questions for Preparers and Auditors

Question 23: Do you believe that the transition provision in this proposed Update is operable? If not, why?

ABA Response: See answers to question 20 and 21.

Question 24: How much time would be needed to implement the proposed guidance? What type of system and process?

ABA Response: See answer to question 22.