American Bankers Association
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Leslie Seidman, Chairman
Financial Accounting Standards Board
401 Merritt 7
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Dear Leslie:

We want to thank you, Tom, Hal, and the FASB staff for meeting with ABA representatives to let us provide some thoughts about the intricacies of the definitions provided and the operational impact of the proposed three bucket impairment model. We found the meeting to be very useful, and noted subsequent to the meeting that our inability to cover our all the agenda items only further demonstrates the complexity of the issue of impairment. It is clear that our combined goals are compatible, but we remain concerned that certain definitions and details within the model may still result in unnecessary confusion and an inability for many banks to operationally deliver the intended results. With these points in mind, we thought it would be useful summarize our views and offer further assistance.

1. *Simplicity and consistency of processes/terms in use today:* The model must be simple and easy to explain. With the large number of community banks[1] and other non-international institutions, the banking industry in the U.S. is different from banking industries elsewhere in the world. As a result, the majority of banks in the U.S. do not normally use credit risk analysis that refers to terms often emphasized in international guidelines, such as probability of default (PD) or loss given default (LGD). These banks typically estimate impairment on loans by extrapolating annual charge-off rates[2] based on historical data, and then applying various qualitative factors based on characteristics within their different portfolios.

   The model must leverage existing credit risk analysis processes. The vast majority of U.S. banks currently rely on common regulatory loan classifications and charge-off systems for both commercial and consumer loans, and they rely on these systems in evaluating and measuring impairment.

2. *Valuation techniques*: If Bucket 1 losses are expected to be based on a one-year PD (or one-year probability of a loss event), we fear that most banks in the U.S. will struggle to effectively comply with the statistical analysis required under the standard. Further, since U.S. banks and banking regulators closely monitor charge-off rates (and charge-off practices), current credit risk practices and analysis already in place would be required to be replaced.

[1] The compliance constraints faced by community bankers are time and resources. Thus, the balance of risks versus rewards of requiring sweeping changes to the evaluation of credit risk along with the ALLL methodology is an important consideration, as the costs could outweigh the benefits.

[2] It is our understanding that U.S. banks typically charge off loans within a shorter time frame than some other major countries.

Based on our understanding, the goal is to have Bucket 1 consist of "pass" loans that do not meet the inherent credit quality triggers to move to Buckets 2 or 3. The valuations would reflect a one year probability of default with a full loss content severity.[3] The one year probability of default should have variation based on forward looking indicators. The industry standard roll rate model was suggested as a tool for this. Our primary concerns about applying "life of loan" losses for those loans that show neither credit characteristic concerns nor deterioration are that it could create much confusion and operational complexity. We would recommend consistent valuation techniques for high quality performing loans that are based on typical loss patterns for the specific type of loan product.

We believe that these systems should be compatible with the three bucket model and, generally, loans currently classified as "pass" will be maintained in Bucket 1. However, we are nevertheless concerned that the three bucket model may limit (and lower) the allowances for many commercial loans that are maintained in Bucket 1, since a "loss event" may not occur within the next 12 months (the measurement objective in Bucket 1) or the criteria to migrate to Bucket 2 are not sufficiently satisfied. As we have expressed before, application of the three bucket model could unnecessarily produce inadequate allowances and, at the same time, introduce unnecessary volatility in the allowances. With this in mind, we recommend that sufficient judgment be emphasized in the implementation guidance to maintain loans and record allowances that the entity believes are appropriate within Bucket 1, given the risk involved. This may include, within the standard, emphasizing the use (and giving examples) of qualitative factors that take into account the nature of the portfolio risks and the point in the economic cycle.

Full loss content should be considered in Buckets 2 and 3.

3. *Inherent credit quality versus tracking credit deterioration*: We believe that tracking deterioration of an asset is impractical and may have unintended consequences (e.g. associated with originating subprime loans that remain in Bucket 1). The inherent credit quality of the asset should be the underlying determination for analysis between Bucket 1 versus Buckets 2/3.

4. *Use of judgment*: Consistent with current practice, management judgment is inherent in all valuation techniques and must be reaffirmed as the most significant factor in evaluating and measuring impairment. Impairment is highly judgmental in nature, and the level of imprecision increases as the forecast period lengthens. Therefore, emphasis on probability-weighted discounted cash flows, which implies that mathematical models can improve the accuracy of such estimates, should be minimized. As is generally understood by banking regulators in the U.S., an acceptable allowance may fall within a range of estimates.

5. *Principal and interest considerations:* With this in mind, any reference to impairment being "both principal and interest", which indicates that for performing loans bankers can accurately estimate the timing of cash flows, should be dropped. In fact, unnecessary language such as "life of loan loss" will create confusion among preparers and users of the financial statements. A "life of loan" concept brings in the same questions that were raised when the Boards were evaluating the "Time

[3] Although we requested earlier in this letter and during our meeting that PD not be required in the standard, we are using it here, as we did in our meeting, solely to help develop a common understanding of the intent of Bucket 1.

Proportionate Allocation", which both miss the main point investors want to know: How much of the recorded balance will be collected? Any consideration of recognizing interest on defaulted loans should be dismissed.

During our conversation, there was reference to "total loss content", which appears to be an improvement over the term "life of loan loss". However, "total loss content" must still be defined. We recommend defining the impairment loss to equal the amount of the recorded investment that exceeds the amount of principal expected to be collected or recovered.

6. *Nonaccrual practice*: The concept of "nonaccrual" loans needs to be maintained. We strongly believe that banks in the U.S. must be allowed to continue the use of the regulatory concept of "nonaccrual" loans, and we believe that the nonaccrual loan concept can be an appropriate application within the definition of "total loss content".

7. *Purchased credit impaired loans*: The accounting for "purchased credit impaired" (PCI) loans must be streamlined. As we discussed with the FASB and the AICPA during the development of the accounting for PCI loans, the accounting for these loans is confusing. We have also heard many times from bank investors that the accounting for PCI loans must be re-worked. We understand that the Boards may intend that the provisions for impairment for PCI loans will reflect both improvement and deterioration immediately in net income, and we support that. However, we also understand that the "net method" of presentation is expected to be retained for the balance sheet and the "gross method" will be required in footnote exposure.

   Banking management and banking analysts do not like the net method of presentation – indeed it is precisely this presentation which confuses them. Not only does it make historic ratio analyses on "reserve coverage" and "net interest margin" extremely difficult to understand, but it also hides the very amount (namely, the approximate principal balance) that is owed by the borrower and that bankers are trying to collect. While we understand that IASB members may generally favor such presentation, we have yet to find any banking analysts who find this presentation useful.

8. *TDR accounting:* Troubled debt restructuring (TDR) accounting must be simplified and improved. There must be clear guidance related to loans subject to modifications that does not create the same problems as in the current accounting for TDRs. We support disclosure of loan modifications in ways that provide useful information related to credit risk. However, the current requirements do not necessarily achieve that objective. Under the current TDR accounting, definitional difficulties have always existed (that is, what is and is not a TDR) and operational intricacies exist (for example, the "once a TDR, always a TDR" syndrome) that far outweigh the benefits provided. We recommend that the TDR concept be discontinued, but implementation guidance be provided as to how a variety of modifications would fit into the three bucket model, including A/B note structures and direct reductions of principal.

9. *Inclusion of debt securities in impairment model:* Debt securities should be excluded from the impairment document. We believe the FASB's 2009 changes to the model for other than temporary impairment (OTTI) essentially repaired the most significant problems with the impairment model for debt securities. Therefore, we see no reason why the three bucket model must be applied to debt securities, especially in a classification and measurement model in which, as FASB is expected to propose, the fair value of the security is reflected on the balance sheet.

On the one hand, most of the debt securities market (for those securities commonly held by banks) is different from the loan market because community bankers often rely on credit risk analysis performed by independent rating agencies. Unless the agencies are able to re-configure how risks are classified and losses are estimated, confusion on which bucket and how to measure the loss will reign.

On the other hand, many debt securities held by community banks are local municipal securities that are not rated and for which the financial information from the municipality is not normally provided on a timely basis (often up to a year after the end of the reporting period). In these cases, except when a loss event (or potential loss event) occurs, internal controls will likely be ineffective in determining the bucket or measuring the allowance. Therefore, neither situation is desirable. Banks should be able to apply the same impairment (in this case, OTTI) rules as are currently followed. The current rules are straightforward, recognize the importance of fair value, and are well understood by investors. If the Boards decide to include debt securities, we strongly recommend that an appropriate level of discussion between the Boards and with industry take place; to date, our focus has been almost solely on loan impairment.

We recognize the challenge in developing a global standard for accounting for impairment and we appreciate the effort and outreach you have performed. Thank you for the time you are spending to try to get this right. Please feel free to contact Mike Gullette (mgullette@aba.com; 202-663-4986) or me (dfisher@aba.com; 202-663-5318) if you would like to discuss our views.

Sincerely,

Donna J. Fisher

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