

May 30, 2013

Technical Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update: Financial Instruments—Credit Losses
(Subtopic 825-15), File Reference No. 2012-260

Dear Ladies and Gentlemen:

The Independent Community Bankers of America (ICBA)¹ appreciates the opportunity to comment on the proposed accounting standards update *Financial Instruments—Credit Losses (Subtopic 825-15)* (ASU). The objective of the proposed ASU is to improve the current delayed recognition methodologies for recording credit losses on certain loans and securities. The proposed ASU shifts the recognition of these credit losses from the current incurred loss model to an expected loss model based on an entity's best estimate of current expected credit losses at initial recognition using forward-looking information. The proposed ASU also simplifies the current complex body of accounting guidance that relies on multiple loss recognition principles and techniques with this simplified expected loss approach.

The proposed ASU addresses current concerns with delayed recognition of credit losses observed during the recent financial crisis of 2008-2009 by dramatically altering the impairment model so that an entity's own estimate of expected credit losses is recognized immediately on a present value basis upon initial recognition of the associated financial instrument. This "too much too soon" approach fails to recognize the true purpose of the loan loss reserve, which most financial statement users and preparers would argue should be the orderly and well-defined recognition of expected credit losses over the expected life of a financial instrument. The proposed ASU also fails to consider the impact of implementing an expected loss model with multiple outcomes on small entities including both public and non-public community banks, whose highly tailored, relationship-based

¹ The Independent Community Bankers of America®, the nation's voice for more than 7,000 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services.

With nearly 5,000 members, representing more than 24,000 locations nationwide and employing more than 300,000 Americans, ICBA members hold more than \$1.2 trillion in assets, \$1 trillion in deposits, and \$750 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

lending model does not easily link with identifiable environmental factors that can accurately depict future economic risks.

Background

Today the financial accounting credit impairment framework for loans and securities follows multiple methodologies where the legal form of the instrument or the method of acquisition drives the impairment technique and the timing of loss recognition in the financial statements. Impairment models vary in complexity and scope across entities with similar assets because instrument ownership forms vary. Pools of homogeneous residential real estate loans are commonly assessed together with impairment based primarily on historical loss experience for similar loans. Unique loan products like commercial loans are impaired under the incurred loss model, where the impact to the financial statements is not recognized without the entity first determining whether credit losses are probable. This incurred loss recognition methodology is often criticized as being a major contributor to the recent financial crisis of 2008-2009 as entities were prohibited from increasing loan loss allowance levels early in the impairment cycle because credit losses were not yet probable even though evidence had appeared early on that the risk of credit loss was significantly elevated.

The proposed credit impairment framework creates a single approach for recognizing credit losses for loans, securities, trade and lease receivables, and loan commitments. The approach would follow an expected loss model created by the entity and would be applied to financial assets like loans and investment securities except for those that are carried at fair value with gains and losses recorded in net income. Impairment would be recognized as the net present value of contractual cash flows not expected to be received as of a reporting date discounted at the instrument's effective interest rate. Expectations for cash flows not expected to be received would be based on past events like historical losses for similar assets, current economic conditions for that asset, and future management expectations based on reasonable and supportable forecasts. An entity would be required to produce at least two possible outcomes and would be prohibited from generating expected losses solely for the most likely outcome. An entity may use a practical expedient for financial assets recognized at fair value with changes in fair value recorded in comprehensive income when both (1) the fair value of the financial asset is greater than or equal to the amortized cost basis and (2) expected credit losses for the financial asset are insignificant.

Once the ASU is adopted, entities would apply the guidance through a one-time cumulative-effect adjustment to the balance sheet. The FASB has not yet determined an effective date for the proposed ASU.

Impact on Community Banks

ICBA has many concerns with the proposed ASU and believes that the expected credit

loss model brings harm to community banks of all sizes, the larger banking sector as a whole, and the overall economy. The proposed ASU will have a disproportionate impact on underserved and rural communities with limited access to credit and borrowers who may be attractive candidates for a community bank loan but present an elevated risk profile during the loan underwriting process. ICBA believes without question that a healthy financial institution must maintain loan loss reserve levels that properly and thoroughly gauge the risk of loss to the institution throughout the economic life of financial instruments in portfolio. However, this proposal is far reaching through its overemphasis on the front-loading of expected credit losses and burdensome and expensive application. Without extensive modifications to the calculation and timing of expected credit losses, community banks, their customers, and their local economies will suffer.

The proposed ASU front loads the recognition of credit losses. ICBA agrees with the board that the present incurred loss model for certain loans results in a delayed recognition concept that does not adequately account for expected losses until it's too late in the credit impairment cycle. However, the day one recognition concept with discounted loss expectations does not remediate stakeholder concerns. In fact, this day one loss recognition concept simply swings the pendulum from delayed recognition to up front recognition, even if expected losses are not forecasted to occur until years later. For community banks that seek to achieve strong loan growth, they are immediately penalized for carrying the financial instrument on the balance sheet.

Because the risk of credit loss is a fundamental component of the coupon income received by the bank and the effective yield recognized on a financial asset, recognition of credit losses in such a disjointed manner with respect to the cash flows violates the spirit of matching income and expenses to the period when they are recognized economically. ICBA notes that FASB recognizes the impracticability or impossibility of matching economic terms of the financial asset through ratable recognition of credit losses and agrees that losses do not occur ratably. However, one cannot help but be confused by the concept of recognizing discounted credit losses at the single point guaranteed to be as far as possible from the actual occurrence of an expected loss event.

The proposed ASU calls for complex modeling. Community banks are local, relationship-based lenders who provide credit to a wide range of diverse borrowers in their local communities by originating highly tailored loan products that meet the specialized needs of a borrower. In community bank underwriting, the ability of a borrower to repay a loan is in many cases based heavily on a historical banking relationship that may extend back many years and multiple generations. Community banks would tell you that they have customers that are effectively “risk free” because they do not default regardless of economic or borrower-specific conditions. ICBA feels that the FASB has considered this banking model in part by appropriately taking steps to recognize the need for management to consider historical loss experience for similar assets.

However, one must recognize that the proposal also requires community banks to forecast future economic conditions that can be reasonably supported by management. Because community banks face prudential regulation from multiple government agencies, and because the principles-based nature of the proposal leaves the utilization of forecasts solely to management, it is quite possible that these prudential regulators could require community banks to change their modeling techniques and/or model inputs based on certain points in the economic cycle. Additionally, because community banks face onsite safety and soundness examinations by these prudential regulators that focus heavily on loan loss reserve metrics, diversity in practice among regulators and their examiners will naturally emerge even for similar size institutions in the same community. As economic conditions in local economies change, these regulators will also face the difficult challenge of assessing the viability of modeling inputs while trying to interpret the significance of divergent modeling outcomes.

The proposed ASU is expensive for community banks. In addition to providing forward-looking information about economic conditions, community banks would be expected to produce a variance analysis on how actual conditions differ from historical observations on losses over time. Additionally, community banks would be required to run at least two projected expected loss scenarios in order to generate an expected loss outcome to record in the financial statements. The proposed ASU does not seek to define which economic conditions are appropriate to consider for certain types of financial instruments. The proposed ASU also does not provide any guidance on when economic conditions should be reevaluated or what level of detail should be sourced to generate an accurate model. Without appropriate guidance on which economic factors should be considered and how they should be weighted in any analysis or modeling, similar institutions that engage in similar lending activities in the same geographic region could reach very different conclusions about appropriate levels of loss provisioning. Community banks would need to dedicate valuable finite resources to model selection, testing, production, and maintenance. They could potentially need to engage in extensive data sourcing, warehousing, and administration that would further strain the organization.

ICBA requests that the FASB not move forward with the expected loss model as proposed in the ASU for financial institutions with consolidated assets of \$10 billion or less. Additionally, ICBA proposes an alternative approach for these organizations. This alternative approach alleviates current stakeholder concerns about the delayed recognition of credit losses under the incurred loss model without introducing an inappropriate and expensive provisioning burden on community banks that does not fairly present the risk profile of the financial assets held by the institution. Under the alternative approach, expected losses on financial assets that have not experienced incurred loss events would be recorded based exclusively on the entity's own historical loss experience for identical or similar financial assets. In the event that sufficient historical loss experience for the entity and/or the financial asset is not available, the entity would use the historical loss experience for that asset as observed by a representative peer group.

The net present value of historical or expected loss estimates or other loss estimates using discounting techniques should not be recognized when an entity first recognizes the financial asset in its financial statements. Rather, historical loss estimates should be recognized in a uniform manner over the expected life of the financial asset consistent with the entity's expectations for the recognition of interest income. Upon the occurrence of an incurred loss event for a particular financial asset where a loss is probable, the entity should apply the current incurred loss model to establish specific impairment for that financial asset. Further accruals of historical loss estimates for that financial asset would cease.

The alternative approach is practical, easy to implement, and solves the three key challenges with the FASB's proposed expected loss model in the ASU. First, the alternative approach avoids the pitfalls of front loading expected credit losses by allowing entities to adopt a uniform approach that better follows the income recognition pattern for the financial asset. Without elimination of the accelerated recognition of expected credit losses, certain investment products like higher yield loans and securities could seriously impair community bank financial statements and regulatory capital positions. Community banks would be forced to make lending decisions based on the impact of the loan on the bank's reserve balances rather than on the ability of the borrower to repay the loan.

Second, the alternative approach eliminates the complex and expensive modeling that would need to be undertaken by community banks if the expected loss model was implemented as proposed. Because the alternative approach is driven principally by an entity's historical loss experience, the need for ensuring that models are capturing the most relevant information is eliminated. Actual credit losses are assessed based on the incurred loss model as it exists today, a model that community banks and their prudential regulators are familiar with and have the current infrastructure in place to understand, review, and maintain.

Third, the alternative approach is simple, straight forward, and easy to implement. The need to dedicate valuable community bank resources to over burdensome modeling procedures is eliminated. Stakeholders can easily understand loan loss reserve metrics while concerns about the delayed recognition of credit losses are mitigated. More importantly, the alternative approach can be applied to a diverse set of financial assets in a straight-forward manner with a consistent approach.

One must not lose sight of the fact that regardless of the technique used to build, manage, and carry the loan loss reserve in the financial statements, the eventual impact of actual observed credit losses over time is the same. Said differently, a more complex and expensive model will not result in a better outcome for actual credit loss experience. Focus should be directed to ensuring that an appropriate level of loan loss reserve has been recorded to establish that future expected losses are sufficiently provided for by the

institution. The alternative approach achieves the same goal as the expected credit loss model in the proposed ASU with a better outcome for preparers, stakeholders, and the financial system as a whole.

ICBA appreciates the opportunity to comment on this proposal. If you have any questions or would like additional information, please do not hesitate to contact me at (202) 659-8111 or james.kendrick@icba.org.

Sincerely,

/s/

James Kendrick
Vice President, Accounting & Capital Policy