CSBS SINCE 1902
CONFERENCE OF STATE BANK SUPERVISORS

May 31, 2013

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

Re: File Reference No. 2012-260

Dear Sir or Madam,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB's) Proposed Accounting Standards Update (proposal, proposed guidance, or proposed update) entitled *Financial Instruments—Credit Losses.* As the professional association of state banking regulators, our feedback centers on the effects we believe the proposal will have on the bank supervisory process and on the institutions our members primarily regulate—commercial banks. CSBS has engaged on numerous FASB proposals over the past few years related to impairment accounting and recognition and measurement of financial assets and liabilities. We commented on the FASB's recognition and measurement proposal in 2010 and the FASB's last credit losses proposal in 2011. In general, we support efforts to improve the current impairment methodology, but we believe any such effort should be carefully implemented.

The FASB's proposal aims to move away from the prevailing incurred loss model of impairment accounting by introducing a Current Expected Credit Loss (CECL) model, which considers more forward-looking information than is permitted under current Generally Accepted Accounting Principles (GAAP). Financial institutions would recognize, at the balance sheet date, an allowance for expected credit losses, defined as *an estimate of all contractual cash flows not expected to be collected from a recognized financial asset or commitment to extend credit.* Information to be used includes information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. The CECL model would replace the multiple impairment models that currently exist for debt instruments, including loans, leases, and debt securities.

In many cases, the incurred loss impairment model led to overstatement of assets during the financial crisis. While acknowledging lessons learned from the financial crisis, FASB should also be aware that adjusting the impairment framework is a change of significant magnitude that will incur transitional costs for banks. We must ensure that the benefit of the proposed changes will outweigh the operational and other costs. Further, FASB should be mindful of the notion that many institutions did not struggle with the prevailing impairment methodology. We should not strive for a framework that introduces radical change. Rather, we should seek a framework that entails practical improvements over existing methods.

As discussed in more detail below, we believe the forecasting expectations outlined in the implementation guidance are not entirely clear. While we support a framework that would grant banks more flexibility to consider forward-looking metrics in their impairment accounting, we do not support a framework that would require institutions to rely heavily on opaque models or make speculative projections about the future performance of an instrument and subsequently account for those speculations.

Importantly, CSBS strongly urges the FASB to thoroughly weigh the impact these standards might have on community banks from a burden and complexity perspective. FASB should clarify expectations in certain aspects of the proposal to ensure the framework is workable and meaningful for community banks. Absent further clarifications and additional work to facilitate transition, the proposed framework may be too costly and lack utility for a majority of financial institutions. Additionally, the framework should not be so complicated that larger institutions, which have the resources and ability to use more complex cash flow models, can gain an advantage over smaller banks through the use of those models in setting reserve levels. In such a complicated framework, the improper use of models could also hamper adequate risk monitoring and assessment by regulators and the institutions themselves.

We have organized additional feedback on the FASB's proposal in the categories below:

CURRENT EXPECTED CREDIT LOSS (CECL) MODEL

The CECL calls on institutions to use information about past events, current conditions, and reasonable and reliable forecasts in estimating expected credit losses. Using information about past events and current conditions is not new; using reasonable and reliable forecasts is new. The proposal requires periodic estimates of the lifetime expected credit losses for all financial assets that are within its scope, which would be recognized as allowances for expected credit losses.

In general, CSBS believes it would be desirable for bankers to be able to consider an appropriate reserve when they estimate that future losses will exceed historical experience. Bankers always have the ability to hold additional reserves as capital, but we believe anticipated credit losses are better reflected in the Allowance for Loan & Lease Losses (ALLL). We believe a problematic aspect of the current framework is that it requires credit deterioration to build to the point where an incurred loss is probable before the deterioration affects the reported financial results. In some cases, this generates a "too little too late" scenario in the allowance for credit losses. The CECL seeks to remedy this issue. Most importantly, we believe the CECL must take a practical approach to incorporating *reasonable and supportable forecasts* in the framework and not mandate unreasonable projections about the economic environment and the lifetime performance of a debt instrument. FASB should thoroughly analyze the costs and benefits of the proposed revisions. If practicality and utility are the driving principles behind the proposed framework, we would support the adjustments.

CSBS does not support a framework that would require unworkable future projections about cash flows. FASB should make clear that financial institution supervisors and management teams should drive expectations about the sophistication of forecasts and how those forecasts could reasonably inform the model. Looking over the life of an asset, as the guidance asks institutions to do, is a speculative and complex process. If the guidance promotes a scenario whereby institutions must undergo significant costs to make projections that are ultimately unreliable, the new framework will fail. As past experience has demonstrated, larger institutions that do have the ability to make sophisticated projections often make significant mistakes in their projections. The guidance must be clearer in this area to avoid improper implementation. In general, FASB should ensure the framework is feasible, practical, and helpful for institutions of all sizes.

In the proposed guidance, FASB acknowledges that methods used to estimate expected credit losses may vary based on the type of financial asset and the information available to the entity that is relevant to the estimation process. FASB explains that given the subjective nature of the estimate, the proposal does not require specific approaches or specific policy election, so there would be latitude to develop estimation techniques that are applied consistently over time and aim to faithfully estimate expected credit losses. While this description of flexibility is helpful, we believe CECL expectations are more clearly explained in the illustrative examples and the Frequently Asked Questions (FAQs) FASB published after releasing the proposal. We strongly encourage FASB to include the concepts conveyed in the FAQs in the final accounting standard. Ultimately, in our view, the most decision useful information for investors does not revolve around the specific reserve techniques. Rather, investors benefit from assurance of a rational and consistent methodology that is not used to smooth earnings.

The FAQs explain that entities would use historical losses as a starting point and evaluate whether and how the historical loss patterns differ from what is currently expected. An entity's ability or inability to obtain or develop reasonable and supportable forecasts of future conditions over the entire life of the loan would only affect the entity's analysis of whether (and how) the historical loss experience *is adjusted* for what is currently expected. FASB further explains that it did not intend to prescribe or prohibit specific approaches or assumptions in how management develops its expectation about the future. CSBS believes this dialogue contained in the FAQs surrounding methods of employing the CECL is helpful and sheds critical light on concepts not fully explained in the implementation guidance. Separately, we note that some institutions which have not been through a recession period may not have a remarkable amount of historical loss estimates on which to base their projections. Given the prominence of historical losses within the context of the CECL model, institutions may benefit from FASB's expectations about a reasonable method for estimating expected credit losses when historical losses are limited.

Taken together, the implementation guidance, the illustrative guidance, and the FAQs seem to indicate a framework whereby an institution would forecast losses over a reasonable period and then revert to historical averages for the remaining life of the instrument. This is likely workable, as few institutions make business decisions without considering expectations about the very near future. However, we believe FASB should be clear about what constitutes a reasonable forecasting period for financial institutions. Specifically, the guidance should clarify that for commercial banks, an adequate forecasting period would constitute 1-2 years. As a practical matter, FASB should also be aware that forecasting may promote inconsistency, as bankers may be ultra-optimistic or ultra-pessimistic about the future. We note the institutions boarding the most risk may be the institutions that do not recognize risk or are reluctant to set aside for impairment, and vice-a-versa. FASB should acknowledge that in the case of commercial banks, ALLL adequacy should rely heavily on the evaluation of the ALLL by regulators and bankers in the supervisory process. The proposed standards should not make it harder for regulators and bankers to arrive at meaningful conclusions about the adequacy of the allowance.

Implementation

The most potentially problematic aspect of the new framework lies in the rigor with which the accounting adjustments are incorporated by the bank supervisors in their examination processes. From our regulatory point of view, we believe it will be important for regulators to be flexible in their evaluation of the ALLL and work with managements' methodologies. The CECL should work around banks' existing risk management systems and frameworks. The FASB's clarification of the CECL model in the FAQs and illustrative guidance should give the regulators the ability to incorporate practical implementation standards in their processes. It is critically important that the FASB make clear in all aspects of the guidance reasonable and practical methods for implementing the standard. More so than other policy proposals affecting a bank's balance sheet, it is difficult to fully understand this proposed guidance without seeing the guidance put into practice. Implementation will be the most important determinant of the guidance's success. Accordingly, we urge FASB to develop and issue a practice guide before the new framework comes into effect.

Further, FASB should continue to work with the banking regulators to help develop some simple models and examples that small banks can lean on in the initial transition. FASB notes in the proposal that it will be conducting field visits with financial institutions to test implementation of the guidance. FASB should ensure institutions of various sizes are included in the field visits and that the information gathered from those visits informs finalization of the rule and any work the FASB does with the banking regulators in facilitating transition. In general, we believe FASB and all the banking regulators should work together upon finalization of a new impairment method to conduct a thorough educational effort for the benefit of the industry, as any such accounting update would represent significant change.

TECHNICAL FEEDBACK

To address more specific technical matters of the proposal, we believe a few of the definitions contained in the glossary warrant further clarity or explanation. Above all, the definition of expected credit loss includes principal and interest. While this is generally intuitive and further explained in the FAQs, we note that including interest may blur the lines between an actual credit loss and a loss of expected *income*. Before finalizing a new model, we believe FASB should further research this topic and ensure the definition of expected credit loss does not induce reserving for future income that has not yet been recognized.

Additionally, we believe two other definitions, while not critical within the context of the proposal, would benefit from additionally clarity. First, we request clarity on whether the definition of "loan commitment," which applies to funded loan commitments, also captures loan commitments that do not have fixed expiration dates, such as demand notes. Secondly, within the context of the definition of "reinsurance receivable," it is unclear whether the term *recoverable* references contractual or expected recoverable amounts.

On a separate topic, CSBS endorses the FASB's decision to use the CECL to evaluate credit impairment for debt securities instead of the existing Other than Temporary Impairment (OTTI) model. Credit losses for debt securities would be recognized using an allowance rather than a direct write-down. This provides the opportunity for reversal of credit losses if expectations about cash flows improve. We believe this is a positive adjustment.

Questions 8 and 9 in the FAQs confirm that prepayments and value of collateral will be taken into consideration in estimating expected credit losses. We believe these are critical clarifications that are not highlighted in the implementation guidance. Additionally, in evaluating question 11 of the FAQs, we believe enhanced clarity is needed surrounding why the estimate of expected credit losses is not characterized as a best estimate. The explanation offered is complex. Importantly, FASB also clarifies in question 11 that it does not expect an institution to employ probability-weighted methods. Finally, question 14 explains an important expectation, in which FASB maintains that forecasts should not always serve to increase the reserve amount. The opposite may be true if conditions are expected to improve.

TRANSITION

In general, CSBS believes FASB should proceed with caution with respect to implementation timing and transition. As referenced above, we endorse issuance of a practice guide and simple examples to help facilitate transition. There may be significant differences or difficulties among institutions in transitioning to a new framework depending on the economic environment. If the economy is heading into a downturn of any kind, the initial implementation could be costly for institutions. In some cases, speedy transition could lead to an unwarranted acceleration of insolvency for institutions in troubled conditions. Separately, to the extent the guidance would require systems adjustments, FASB should incorporate an appropriate transition period. The proposed guidance should not undermine the effort to generate stability in the banking sector.

OTHER ISSUES

As discussed in other aspects of the letter, we reiterate that the FASB should ensure the new impairment standards are not unworkable for small banks. In the current regulatory compliance environment, in which institutions are processing new Dodd-Frank and Basel III standards, any change of this magnitude must yield overt benefits and not result in increased burden. Further, the proposed changes are likely to result in increased emphasis on documentation and record retention. While commercial banks are increasing documentation sophistication, FASB should be aware that technological adaptation is uneven across the industry.   FASB should also be aware that many community banks engage in more specialized lending than larger institutions. The CECL model should incorporate flexibility to acknowledge less standardized categories of loans that are built to serve the unique needs of communities. Ultimately, the FASB should work with the newly created Private Company Council (PCC) to ensure these standards are reasonable and practical for smaller financial institutions.

We support the FASB's effort to streamline current impairment literature for debt instruments. The proposal would effectively cut down current relevant impairment guidance from over one hundred pages to just over thirty pages. This will help institutions across the industry with compliance.

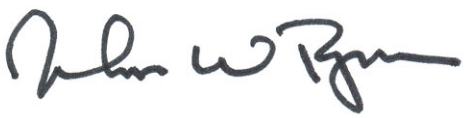
CONCLUSION

An impairment framework that allows institutions to build stronger reserves by considering more forward-looking information than is currently permitted under GAAP would benefit the banking system. However, CSBS believes FASB's proposed guidance needs further clarity to ensure the framework is not model-driven and does not require unworkable forecasts. Further, in a rapidly changing regulatory environment, it is critical that the benefits of any changes to the impairment accounting framework outweigh the costs. Finally, FASB should proceed with caution in implementation and work with banking regulators to develop helpful tools to facilitate transition for smaller financial institutions.

Thank you for the opportunity to comment on this important proposal.

Sincerely,

John W. Ryan



President and CEO