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**American Bankers Association - 1 - 800 BANKERS**

**Welcome to ABA CFO Bullets**

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**SEC Notes Areas of Frequent Comment on Disclosures**

As it has in the past, the Division of Corporation Finance at the Securities and Exchange Commission has published their “Areas of Frequent Staff Comment – Financial Institutions”. The document addresses two kinds of issues: those where comments will likely be issued if appropriate disclosures are not provided and those where enhanced disclosure will likely be required to understand the bank’s financial and liquidity position or results. Of course, the topics include asset quality and impairment. However, the presentation also addresses many other issues, including FDIC-assisted transactions.

This slide presentation will be helpful to all banks, whether publicly-held or private, as auditors will likely use this as points of focus during their year-end work.

To access the presentation, [click here](#).

**FASB Goes Back to the Drawing Board on Mark to Market**

Citing outreach activities in which “almost all” constituents believe that amortized cost is significantly more relevant for purposes of measuring most loans, the Financial Accounting Standards Board (FASB) agreed to consider amortized cost as a primary attribute (in addition to fair value) for measuring financial instruments. In doing this, FASB also directed their staff to propose accounting models for financial assets that differ from the one proposed in their recent exposure draft (ED).

What does this all mean? Is mark to market accounting (MTM) dead? No. FASB will likely consider other accounting models that may actually expand MTM from what is required today. Almost for sure, loans held

for sale and trading securities will continue to be based on fair value (FV). Additionally, as proposed in their ED, hybrid assets and other assets with highly variable cash flows (such as interest-only strips) will likely be marked to FV, with changes going through income. Based on the action today, however, simple loans appear as though they will be put in an amortized cost “bucket”, though it is very possible that FVs of these loans will be parenthetically disclosed on the face of the balance sheet.

The big issue is how to treat debt securities. Many have no observable market price, or may have an observable price only at certain times. Based on today’s meeting, FASB appears to be leaning toward a model where securities in an active market (with an observable price) would be accounted for at FV, with changes in FV going through other comprehensive income (OCI) – even if the bank’s strategy is to hold until maturity. However, they are stymied because, as shown during the financial crisis, those markets may dry up. What do you do then?

FASB staff members are likely to propose defining a business strategy that reflects an entity’s intent on assets that are “held for the long-term, but the first to go if needed for liquidity purposes.” We believe this “bucket” of assets will have FV changes recorded through OCI. This could result in some securities now classified as held-to-maturity to be reported at FV.

While there is uncertainty where FASB will land on this, we do know that more disclosure addressing liquidity risks (and related asset/liability management) will be required. Liquidity risks were not addressed in the ED and FASB may find it necessary to expose and issue a new requirement outside of this project. Along with the recently-issued requirement to expand credit risk disclosures, FASB believes that the key risks of a banking institution – credit risk, liquidity, and capital adequacy – will be appropriately reflected.

We expect FASB to make a decision prior to the end of January on the accounting model, though they will probably discuss this issue once more in public prior to that.

If you have any questions, please contact [Mike Gullette](#).

### **FASB, IASB to Request Input on Two Proposed Impairment Models**

Still struggling in their efforts to issue a converged standard on measuring asset impairment, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have agreed to send out a “supplemental document” that requests input related to two impairment models being debated by the boards. The supplemental document, which applies only to loans that are evaluated within a portfolio (not individually), is expected to be issued in January 2011 and replaces a formal exposure draft that IASB was planning to release. In the document, we expect most of the focus to be on the IASB-proposed model, which FASB members accept, though they do not prefer. Also to be included in the document will be the model preferred by the majority of FASB members.

Both models are responding to the “too little, too late” criticisms that have been voiced over the past few years. Therefore, bankers should expect higher – and perhaps, significantly higher – allowances for loan and lease losses (ALLL) than are currently recorded under the so-called “incurred loss” approach. ABA is concerned that this will provide a “double whammy” to banks, since capital requirements will be increasing as a result of the recent Basel accord. Higher reserves and higher capital requirements could mean very little lending.

In both models, losses on bad loans are booked immediately, similar to current “FAS 114” requirements. In the IASB model, for loans not identified as bad (the “good” book), the model requires an estimate of losses over the expected life of the portfolio. If your historical data indicates you lose 2% over time, that is the expected loss amount. That expected loss is amortized into your ALLL over the expected life of your portfolio. So, if the weighted average life of your loan portfolio is two years and has an expected total life of 5 years, your ALLL balance is the amount you calculated for the “bad” book of loans, plus 2/5 of the

expected loss for the “good” book. In any event, the total ALLL will have a “floor” amount of the losses expected over the foreseeable future and no less than one year.

FASB members have expressed reservation about the operational complexity of the IASB model. Believing that the vast majority of losses in a loan portfolio occur within 2 to 3 years after origination, they prefer that banks merely estimate losses over the next two to three years. Essentially, they are requiring a “life of loan” loss estimate. But as a practical expedient, they think the 2 to 3 year timeframe is operational to banks and also will capture the lion’s share of total losses expected in a portfolio. Further, FASB believes that the “floor” of the IASB model will kick in most of the time, making the IASB model fundamentally equal to the FASB model. With this in mind, they think “Why go through all the rest of the hoops of the IASB model?”

Many issues still need to be addressed related to each model. For example, “What will actually qualify as a “bad” loan?” and “How will the expected life of the portfolio be audited?” are critical questions. FASB’s model reduces the loss period. But bankers struggle to estimate losses any further than several months in many cases. So, the 2 to 3 year window might not work, either. These issues will likely be points of focus within the document to be issued.

We are expecting a 60 day comment period on the document. As this issue will have an enormous impact on banks, when the document is released, expect ABA to assist institutions in understanding the mechanics of the models and their impact to their operations.

If you have any questions or comments on the models, please contact [Mike Gullette](#).

### **Auditors to Focus on Loan Repurchase Liabilities, Disclosures**

As a point of emphasis for upcoming year-end audits, CPA firms across the country are starting to focus on how banks are identifying liabilities related to contingent loan repurchases. Citing representation and warranty provisions in their purchase agreements, the government-sponsored enterprises have ramped up efforts to require banks to repurchase loans previously sold to them. Many bankers believe a large portion of the repurchase requests have been nit-picky, though the requests are intended to be based on underwriting errors or other significant issues that question whether the related loans are “conforming”. The same issues apply to private-label securitizations and to other loan guarantors.

Auditors will be looking to see how banks are estimating and disclosing any liabilities related to these requests, and many smaller firms have been waiting for the “big boys” to provide more guidance. Well, that guidance is now here. The Public Company Accounting Oversight Board (PCAOB) just issued Staff Audit Practice Alert No. 7 Auditor Considerations of Litigation and Other Contingencies Arising From Mortgage and Other Loan Activities. The Alert gives guidance on evaluating “FAS 5” loss contingency estimates and disclosures, as well as communication with audit committees and other issues.

So, if you want to know how your auditors will be addressing this issue, a good place to start is the PCAOB.

If you have any questions, please contact [Mike Gullette](#).

[Read the PCAOB document.](#)

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