July 15, 2016

Via Electronic Mail

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 – Basel Switzerland

Re: Consultative Document on Prudential Treatment of Problem Assets – Definitions of Non-performing Exposures and Forbearance

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("The Clearing House"),[1] appreciates the opportunity to respond to the request for comment by the Basel Committee on Banking Supervision (the "Basel Committee") regarding its above-captioned document setting forth its proposal regarding Definitions of Non-performing Exposures and Forbearance (the "Proposal").

We appreciate the Basel Committee's desire to develop harmonized criteria for categorizing loans and debt securities, in order to improve supervisory asset monitoring and dissemination of data for asset quality indicators on a system-wide basis. However, we are concerned that the Proposal will affect current accounting and financial statement disclosure requirements, even though that is not necessarily the intended result. As a result, we suggest that the Basel Committee reconsider revising the proposed definitions to align them more closely with credit risk management practices to avoid creating an entirely new framework that may impact U.S. GAAP and IFRS financial statements without a corresponding improvement in credit risk measurements.

[1] The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by building a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly $2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

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I. Executive Summary

- The proposed definitions should be revised to align more closely with credit risk management practices to avoid creating an entirely new framework that may impact U.S. GAAP and IFRS financial statements without a corresponding improvement in credit risk measurements.

- The Proposed definition of Non-performing Loans is overly restrictive and should allow for more flexibility for certain loans and loan features, as follows:

  - The 90 days past due cutoff for classification as non-performing should not apply to all types of loans such as credit cards and other loans that are risk managed differently.

  - Where loans are adequately collateralized and in process of collection, or subject to a government guarantee, they should not be considered non-performing; protective features of loan commitments should also be taken into account when assessing non-performance.

  - The assessment for non-retail exposures should continue to be done at the individual loan level in order to more accurately reflect how bankers assess the risk of these exposures.

  - Purchased Credit Impaired (PCI) loans should be excluded from the scope of the Proposal as statistics regarding the individual loans in the pool do not accurately reflect the performance of the pool as a whole.

- The definition of Forbearance overlaps with that of Troubled Debt Restructurings (TDRs); the definitions of a TDR and a Forborne loan should be conformed.

- The scope of the Proposal should exclude debt securities due to the different features of these instruments and the different way in which they are risk-managed and disclosed.

- The concept of materiality should not be defined in the Proposal as it is beyond the scope of the Proposal and is already defined by the SEC and the FASB.

- The Proposal should allow for sufficient implementation time and should not be applied retrospectively.

A discussion of each of these points follows.

II. Discussion

A. The proposed definitions should be revised to align more closely with credit risk management practices to avoid creating an entirely new framework that may impact U.S. GAAP and IFRS financial statements without a corresponding improvement in credit risk measurements.

The Proposal states that "[t]he definitions have been designed to complement existing accounting definitions used in various jurisdictions, and in no way undermine the definitions used therein which are focused on the accuracy of impairments and provisions in financial statements. Nor are they designed to replace existing definitions of default which are used in Internal Ratings-Based (IRB) approach or proposed standardised approach for credit risk."[2] From this, we understand that the new proposed definitions are not intended to impact the accounting for impaired loans under U.S. GAAP or IFRS, either as they exist currently, or when the new credit impairment standards go into effect. However, we believe that, instead of complementing existing accounting standards, the new definitions may compete with existing accounting and disclosure requirements. As a result, we believe the Proposal may create further confusion by introducing a new framework for both accounting for and disclosure of non-performing loans.

For example, we note that under IFRS 9, the notion of default is fundamental to the loss provisioning model. Specifically, if credit risk has increased significantly since initial recognition, the credit loss allowance is measured at lifetime expected credit losses. IFRS 9 explains that changes in credit risk are assessed based on changes in the risk of a default occurring over the expected life of the financial instrument. While the term "default" is not itself actually defined in IFRS 9, an entity is required to apply a definition of default that is consistent with how it is defined for its normal credit risk management practice; and there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due. We understand that many banks intend to align their regulatory and accounting definitions of default. Accordingly, we believe there is a good chance that many institutions may feel compelled to adopt the Proposal's definition of nonperforming loans and incorporate it into the loan loss provisioning model. As a result, we believe that the Basel Committee should be cognizant of the potentially far-reaching implications of the Proposal.

In addition, the Proposal states that the guidelines are intended to be used in Pillar 3 disclosures; and that "[s]pecific disclosure proposals will be developed as part of the Basel Committee's ongoing review and update of the Pillar 3 requirements."[3] It is unclear as to whether these disclosures are intended to be made only for regulatory reporting purposes or

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2 Proposal ¶9.

3 Proposal footnote 2.

would be required to be included in the U.S. GAAP financial statements. If the former, we are concerned about introducing differences between regulatory accounting principles ("RAP") and U.S. GAAP, as U.S. banking regulators have stated that they do not support the creation of such "RAP-GAAP" differences. If, on the other hand, the disclosures are intended to be included in the U.S. GAAP financial statements, we are concerned that they may prove confusing to investors, as U.S. banks already disclose similar metrics in their financial statements, and thus additional reconciliations may be required to explain the differences between the various metrics.

We recommend that the proposed definitions of non-performing loans be aligned more closely with credit risk management practices. We believe that the definitions of non-performing loans that are used by the U.S. banking regulators do in fact align quite closely with such credit risk management practices; banks that are subject to such definitions have many years of experience applying these definitions to a myriad of fact patterns, and the U.S. bank regulators are equally experienced in supervising and monitoring the application of these definitions. We suggest that the Basel Committee redeliberate its definitions, as we believe that the proposed changes will merely introduce confusion among both banks and investors without improving risk measurement in a meaningful way.

B. The Proposed definition of Non-performing Loans is overly restrictive and should allow for more flexibility for certain loans and loan features.

While we appreciate the Basel Committee's attempt to harmonize the definition of non-performing loans, we believe that a one-size-fits-all model may not adequately capture the nuances of the many different types of loans in the marketplace as well as various loan features that provide additional protection to lenders. We describe these issues further below.

1. The 90 days past due cutoff for classification as non-performing should not apply to all types of loans such as credit cards and other loans that are risk managed differently.

The Proposal states that material exposures that are more than 90 days past due are to be considered as non-performing. We acknowledge the fact that for many types of retail loans, 90 days past due is a commonly used metric for non-performing loans. However, for certain retail loans, such as credit card loans, many banks do not consider them non-performing until a greater amount of time has passed, such as 180 days. Due to relatively quick loan modification/ repayment programs for these types of loans, a 90 day past due definition would not give credit for meaningful work-out processes by the bank. In addition, a 90 day past due cutoff would result in a loss of comparability from period to period, as many of these exposures are written off in a relatively short time frame. Similar issues arise with respect to residential mortgage loans secured by a 1-to-4 family residential property, which are not required to be considered non-performing under U.S. regulatory guidance until 120 days past due.[4]

Accordingly, we believe that the Proposal should provide for greater flexibility in defining non-performing for other types of loans. As the Proposal states, paragraph 452 of the Basel framework allows for a supervisor to substitute for the 90 days figure for different products as it considers appropriate to local conditions; we believe this approach should be applied to these types of loans. An alternative approach would be to permit the use of the same type of statistics as are currently used in the IRB approach.

2. Where loans are adequately collateralized and in process of collection, or subject to a government guarantee, they should not be considered non-performing; and protective features of loan commitments should also be taken into account when assessing non-performance.

We disagree with the position that collateral should not be considered in the assessment of non-performing loans. Under U.S. regulatory guidance, non-performing classification can be avoided if the loan is well-secured and in the process of collection.[5] We believe this approach makes sound business sense because the assessment of collateral is a critical part of the credit extension process. Moreover, certain loans (including real estate construction loans, inventory loans, and other types of loans) are underwritten with the expectation that repayment will come from liquidation of collateral in the ordinary course of business. Therefore, ignoring the existence of adequate collateral supporting a loan exposure would result in an unintended distortion of the level of a bank's credit risk.

We recommend that the Basel Committee reconsider its guidelines regarding collateral. At a minimum, we recommend that the Basel Committee explicitly acknowledge that certain loans are extended with the expectation that repayment will come from liquidation of collateral in the ordinary course of business, and in those cases, paragraph 24 (iii)(b) of the Proposal would not apply.

A related issue is that of loans that are subject to a guarantee. For example, in the U.S., student loans and some mortgage loans are guaranteed by U.S. government agencies. Thus, even if the loan is 90 days past due, it is generally considered collectible given the guarantee, and is not required to be placed on non-performing status. We believe the Basel Committee should provide for a similar exception.

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4 Federal Financial Institutions Examination Council ("FFIEC") 031-041 Glossary.

5 See, for example, FDIC Law, Regulations, Related Acts, Section 5000, Uniform Retail Credit Classification and Account Management Policy.

A similar issue pertains to certain loan commitments that may have protective or conditionality features that are designed to allow the issuer to walk away under certain facts and circumstance. Although some commitments may be nominally non-cancellable, there may still be other protections for lenders included in the agreements. The Basel Committee should address this and allow for assessment of protective features and exception from non-performing status in certain cases.

Finally, the Proposal states that "[f]or off-balance sheet items such as loan commitments, the entire uncancellable nominal amount should be reported as non-performing."[6] It is unclear what exactly is meant by "the entire uncancellable nominal amount." For example, if a bank has entered into a loan commitment for $10 million, and $3 million has been drawn and is a non-performing loan, we believe that only the remaining undrawn amount of $7 million should be reported as a non-performing loan commitment, as the drawn amount of $3 million is separately required to be reported as a non-performing loan.

3. The assessment for non-retail exposures should continue to be done at the individual loan level in order to more accurately reflect how banks assess the credit risk of these exposures.

The Proposal states that, in the case of exposures to a non-retail counterparty where the bank has more than one exposure to that counterparty, the bank must consider all exposures to that counterparty as non-performing when any one of the exposures is non-performing. In other words, non-performing status should be applied at the level of the counterparty.[7]

We are concerned that this will unduly complicate the assessment. For example, it is not clear how expansively counterparty will be defined, i.e., will it include all related parties and affiliates as those terms are currently defined in U.S. GAAP? Or would those types of related parties be considered "connected counterparties" as referred to in paragraph 28 of the Proposal? In addition, the terms "retail" and "wholesale" are not defined; small and medium-sized entity (SME) borrowers may be categorized as retail loans by some banks and as wholesale loans by others.

More fundamentally, this approach does not reflect how banks normally assess risk, as typically, these exposures are underwritten at different times, and take into account the underlying collateral provided. We are concerned that the approach in the Proposal will distort the amount of non-performing loans reported. If other exposures to the counterparty do not evidence that full repayment of principal and interest is unlikely, and/or are adequately collateralized, we do not believe they should be classified as non-performing.

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[6] Proposal, ¶23.

[7] Proposal, ¶27.

Accordingly, we recommend that the Proposal be revised to allow for the assessment of non-performing to be performed on a transaction-by-transaction basis, as is done currently, and that designating an individual loan as non-performing should not mandatorily lead to designating all exposures to that counterparty as non-performing. However, we are not opposed to guidance that states that designating an individual transaction as non-performing should consider as one of the inputs the other exposures to that same counterparty or group of related counterparties.

4. PCI loans should be excluded from the scope of the Proposal, as statistics regarding the individual loans in the pool do not accurately reflect the performance of the pool as a whole.

PCI loans are subject to specialized accounting and disclosure requirements.[8] These accounting requirements allow for pooling, which effectively treats multiple retail loans as a single instrument. Specifically, acquired retail loans with deteriorated credit quality that have common risk characteristics may be pooled and accounted for at the group level. As a result, while statistics can technically be provided for the individual loans in the pool that are 90 days past due, these statistics do not accurately reflect the accounting that has been applied to the pool. TDRs offered to these borrowers then often significantly improve the cash flow prospects over those initially priced into the loan. Therefore, a non-performing or forbearance status related to these assets would greatly distort the economic risk of the bank. In addition, under the FASB's new impairment standard,[9] many more loans may qualify for PCI accounting treatment. Accordingly, we recommend that PCI loans be excluded from the scope of the Proposal. If PCI loans are included, however, the Proposal should make clear that the measurement of unlikeliness to pay should be with reference to the amount a bank stands to lose, not the original stated amount of a PCI loan (that is, if a bank has purchased a $100 loan at $60 and expects to realize $65, the borrower's ability to pay should be measured at $60 and not $100).

C. The definition of Forbearance overlaps with that of TDRs; the definitions of a TDR and a Forborne loan should be conformed.

We note that the proposed definition of Forbearance is similar to, but not the same as, the definition of TDRs under U.S. GAAP.[10] Given the significant overlap between the two, we believe it may be confusing to investors if institutions subject to U.S. GAAP must report both categories. Accordingly, we suggest that the Basel Committee work closely with the U.S. banking regulators and the FASB to agree upon a single, common definition.

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[8] ASC 310-30.

[9] ASU 2016-13—Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.

[10] ASC 310-40-15.

In addition, we commend the Basel Committee for including criteria for exit from the forborne exposures category (section 4.2 of the Proposal). Currently, under U.S. GAAP, once a loan is classified as a TDR, it remains classified as such, notwithstanding subsequent improvements in the credit quality of a loan and/or financial condition of the borrower.[11] As a result, we believe that the current approach to disclosure of TDRs may be misleading since many users may interpret that classification as having a higher probability of default in the near term, which may not always be the case if borrower performance has improved. Thus, while we believe that the Basel Committee's inclusion of criteria for exit from the forborne exposures category represents a clear improvement over U.S. GAAP, this distinct difference between "Forbearance" and "TDR" may be confusing for users if the differences are not conformed.

D. The scope of the Proposal should exclude debt securities due to the different features of these instruments and the different way in which they are risk-managed and disclosed.

As drafted, the scope of the Proposal extends to both loans and debt securities. We note that both U.S. GAAP and IFRS already have significant accounting and disclosure requirements for debt securities. We are aware that at times, there can be a fine line between a loan and a debt security, especially where the debt security is issued pursuant to a private offering. However, debt securities that are issued as part of a public offering should be excluded from the Proposal. The reason for this is that the credit risk of public debt securities is managed very differently from loans, which typically allow for direct communications and negotiations with the borrower to allow for workout scenarios, whereas public debt securities typically do not.

Moreover, some debt securities only pay interest on a semi-annual basis, such that a 90 days past due cutoff would not be meaningful and, therefore, including them would overstate the metrics on nonperforming loans. This is especially the case if such securities are subject to a government or government agency guarantee. According to the strict requirements of the Proposal, such a guarantee would not be permitted to be considered in classifying the security as non-performing; however, the existence of such a guarantee would suggest that classification as non-performing is not appropriate.

Furthermore, debt securities are currently subject to extensive financial statement disclosure regarding gross unrealized gains and losses, including disclosure of those securities that are in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer.[12] This disclosure

11 ASC 310-40-40 and 310-40-50-2a.

12 ASC 320-10-50.

provides additional transparency regarding these credit exposures and further makes their inclusion in the scope of the Proposal unnecessary.

E. The concept of materiality should not be defined as it is beyond the scope of the Proposal and is already defined by the SEC and the FASB.

The Proposal sets forth the following definition of "material":

> "an exposure that hits the materiality threshold in force in a given jurisdiction. Materiality thresholds may differ for retail and non-retail exposures, but should comprise a relative and an absolute threshold. The materiality threshold should be applied by reference to the counterparty's aggregated exposure or past due amount as determined by supervisors, without reference to the bank's parameters." [13]

While we agree that materiality is a fundamental concept that should be considered when applying the definitions in the Proposal, we believe it is beyond the scope of the Proposal to set forth a definition of materiality. For example, materiality is defined in the U.S. by the SEC.[14] In addition, the FASB has recently released two exposure drafts that would amend and clarify the concept of materiality.[15] Having a separate definition of materiality that applies specifically to the requirements in this Proposal would create unnecessary confusion. We recommend that the definition be eliminated.

F. The Proposal should allow for sufficient implementation time and should not be applied retrospectively.

The Proposal is silent regarding the effective date. We urge the Basel Committee to allow for a sufficient amount of time to implement the final guidance given that any change from current practice, combined with the upcoming requirement to implement the new standards on impairment of financial instruments recently issued by the FASB and the IASB, will require substantial changes to existing systems and procedures by banks. In addition, it should also be made clear that the proposed guidance is not intended to be applied retrospectively or require any restatement of any reporting or disclosures.

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13 Section 3.1, Definition of non-performing exposures, Explanation of terms (p. 9).

14 SEC Staff Accounting Bulletin No. 99 – Materiality.

15 Proposed ASU—Notes To Financial Statements (Topic 235): *Assessing Whether Disclosures Are Material;* and Proposed Concepts Statement—Conceptual Framework For Financial Reporting Chapter 3: *Qualitative Characteristics Of Useful Financial Information*, both issued September 24, 2015.

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The Clearing House appreciates the opportunity to comment on the Proposal. If you have any questions, please contact the undersigned by phone at (212) 613-9883 or by email at david.wagner@theclearinghouse.org.

Respectfully submitted,

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