



September 23, 2010

Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7, PO Box 5116 Norwalk, CT 06856-5116

Dear Mr. Golden:

Re: Accounting for Financial Instruments (File Reference No. 1810-100)

On behalf of the California and Nevada Credit Union Leagues, I appreciate the opportunity to comment on the above-referenced proposal, which would modify GAAP to require most financial instruments to be marked to market ("fair value") on the balance sheet—including loans. In addition, the changes would require loan loss reserves to be measured on a forward-looking "expected loss" basis instead of the historical "incurred loss" method currently used. By way of background, the California and Nevada Credit Union Leagues (Leagues) are the largest state trade associations for credit unions in the United States, representing the interests of more than 400 credit unions and their 10 million members.

Background on Credit Unions

There are currently 7,602 credit unions in the U.S., serving 92 million members, with assets totaling \$916 billion. A majority of these credit unions (53%) are small, having less than \$20 million in assets and an average of 3.5 full-time equivalent employees. As not-for-profit financial cooperatives with mostly volunteer boards, credit unions have long had a mission of serving those of modest means. In fact, it is the cooperative philosophy and structure of credit unions that allow credit unions to pay dividends to their members (not shareholders) and offer them lower loan rates, higher savings rates and fewer service fees.

However, credit unions are subject to some restrictions which banks and other financial services providers are not. They are restricted by statute to a limited field of membership composed of specific groups or those in a geographical area. In addition, credit unions are the most heavily regulated of all financial institutions, operating within limitations on business lending, loan interest rates, loan maturities, investments, and a host of other restrictions that don't apply to banks. Further, credit unions are limited to accumulating capital through earnings only (they are not allowed access to capital markets) and are restricted on secondary capital alternatives. Finally, due to their structure, limitations, historically conservative business practices, and long-term focus on their members, a majority of credit unions are portfolio lenders, even on real estate loans.

The Leagues' Position

In light of the credit union framework and environment described above, we are forced to conclude that the proposal to mark loans to market is 1) unrealistic in practice; 2) significantly and unnecessarily burdensome on credit union resources and balance sheets; and 3) ultimately harmful to credit union members—and U.S. consumers—who have come to depend on the lower loan rates and fees that credit unions provide. Our concerns and opposition to the proposal are such that we must urge the FASB to withdraw the exposure draft as proposed. In our view, it appears to be at odds with the Board's stated intent that the proposal "provide financial statement users a more timely and representative depiction of an entity's involvement in financial instruments, while reducing the complexity in accounting for these instruments."

Unrealistic in Practice

Simply put, requiring fair value measurement of loans does not realistically reflect credit unions' (and likely many banks') business model. For portfolio lenders like credit unions, loans are not made with the expectation that they will be sold. Rather, they are made with the intent to hold them for the purpose of collecting the contractual, amortized cash flows until maturity. The amortized cost—which generally represents the amount owed by the borrower, adjusted for net fees with premiums and discounts—is most reflective of the cash that will be received (supplemented, of course, by a robust loan loss reserve process). Even when a member/borrower experiences financial problems, the first response of a credit union lender is not to contemplate liquidating the loan, but to attempt to work out the loan terms to the member's—and credit union's—best interests. So, in most cases, market value is irrelevant to credit union management (and to credit union members).

In addition, measuring fair value in an inactive market continues to be an extremely difficult and highly subjective endeavor. Valuing financial liabilities is not the equivalent of a transfer of an asset from a willing buyer to a willing seller. Many financial liabilities are not transferable, making fair valuation very challenging, if not impossible. As an example, loans made to small and mid-sized businesses currently have no liquid/active market. How, for instance, would a credit union located in a small town in central California value a loan made to a local drug store? Determining a fair value for these loans would have to take into consideration the illiquidity for them, thus creating an artificially low market value.

The Leagues believe that a realistic measurement basis for financial instruments should be determined by the business model and strategy of the entity. For loans made by most credit unions—and many banks—that model and strategy is based on the amortized cost of a loan, which provides an objectively verifiable and understandable accounting basis. Implementing fair value for loans would serve to flip this fundamentally sound model on its ear, making the *accounting* the driver of the business model, instead of the other way around. We strongly believe that this is ill-advised and detrimental to prudent management and sound financial reporting.

Significantly and Unnecessarily Burdensome

Marking loans to market would add significant and unnecessary costs to credit unions' operations, without any additional benefit to credit unions or their members. Much of the increased costs would be related to use of outside firms to value financial instruments, and increased costs for the resources necessary to gather and analyze needed information. One \$200 million-asset credit union has estimated that the proposed changes would result in approximately \$40,000 in additional annual costs, primarily in outside vendor costs to determine fair value. Even a conservative extrapolation of this estimate would indicate an additional financial burden on U.S. credit unions well in excess of \$100 million per year. For many credit unions, this additional expense would represent a significant portion of their overall expenses. In addition, the proposed requirements for the Allowance for Credit Losses (accounting by class and by pool versus individually assessed loans) represent an immense increase in complexity—and additional resources—with little or no discernible benefit.

Credit union balance sheets would also be adversely affected, as their net worth (i.e., capital) would largely be dependent on the fair value of assets with no active markets. In addition, moving from a historical basis to future expected losses to include fair value will significantly impact impairment funding, ultimately effecting net worth. (In fact, in many instances the proposal would require credit unions to record life of loan credit losses through net income at the time of loan origination.) This will have a drastic effect on the stability and reliability of credit union capital levels. Such an effect cannot be readily rectified, as credit unions are limited to accumulating capital through earnings only, and are restricted from secondary capital alternatives. Given the current precarious state of the economic recovery, this would only serve to undermine the vitality of U.S. credit unions.

Harmful to Credit Union Members and U.S. Consumers

The bottom line is that the requirements in the proposal, if implemented, will serve to harm credit union members—as well as all U.S. consumers—in a number of ways. First, the higher operational costs and adverse effects on capital levels associated with the fair value model may eventually drive out product offerings that are subject to greater fair value volatility. This would include, for example, loans with long-term fixed interest rates, or loans to those with lower credit scores. Second, these same factors could serve to drive up loan rates and/or fees. This is especially important for U.S. consumers as a whole, as the lower rates and fees offered by credit unions have long served as a competitive determinant of bank rates and fees in local consumer lending markets. Third, lending to small businesses could be significantly curtailed. As we mentioned earlier, loans made to small and mid-sized businesses currently have no liquid/active market. This could force credit unions and other business lenders to limit lending to very short-term loans to only the highest quality borrowers, as longer term loans would carry

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¹ The Determinants of Bank Rates in Local Consumer Lending Markets: Comparing Market and Institution-Level Results. Journal article by Robert M. Feinberg; Southern Economic Journal, Vol. 70, 2003

the fear of possible write-downs, even for loans that are being paid as agreed. As a result, a five-year loan to a farmer, local restaurant, drug store, towing company, or clothing store would be a thing of the past. Such a loss could prove to be devastating to small business owners, and crippling to a still-fragile and recovering economy.

Fourth, the FASB's exposure draft states: "The proposed guidance focuses on providing the most useful, transparent, and relevant information to investors about the financial assets and financial liabilities of an entity." The Leagues believe that, for credit unions, the opposite of this intent will be the result. The proposed requirements introduce complexity that most credit union members do not need or want. Since the accounting under mark-to-market will not reflect how a credit union is managed, the result will be more complex—and confusing—financial statements. This is likely to result in members misunderstanding a credit union's financial performance. This, in turn, could result in unwarranted public relations challenges, as financial statements subject to mark-to-market valuations will not reflect a credit union's true strategy, management, or operations regarding financial instruments. This type of scenario is likely to play out across industries other than the credit union industry, and we find it deeply troubling that the FASB does not appear to have placed much weight on the comprehensive effects that this aspect of the proposal is likely to have on the market.

FASB's Divergence from IASB and Other Bodies

Finally, we are perplexed and disturbed as to why the FASB has chosen to present an exposure draft that deviates so significantly from the basic principles for financial reporting that were previously discussed—and jointly affirmed—with the IASB. The FASB exposure draft has taken a very different approach to financial instruments reporting than that taken by the IASB. While the FASB's approach proposes that all financial instruments are reported at fair value, the IASB seeks to retain some of the existing financial instruments accounting model that used a combination of fair value and amortized cost, depending on the nature of the financial instrument.

Also, as the FASB no doubt realizes, disagreement about the FASB exposure draft is global, going beyond the IASB to include the Basel Committee, the G-20 nations, other nations' financial accounting reporting boards, and many regulators. Further, we point out that a PricewaterhouseCoopers survey² of 62 investors and analysts across a geographically diverse sample found some of the following consistent response trends:

• A majority of respondents favor a mixed measurement model, with fair value reporting for shorter lived instruments and amortized cost reporting for longer lived instruments (particularly loans and deposits) when the company intends to hold those instruments for the purpose of collecting the contractual cash flows.

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 $^{^2\} http://www.ukmediacentre.pwc.com/News-Releases/Investors-and-analysts-add-to-the-critical-fair-value-debate-ea8.aspx$

- Respondents that favor the mixed measurement model think the information better reflects an entity's underlying business and economic reasons for holding an instrument. They also stress the importance of keeping net income free from fair value movements in instruments that are held for long-term cash flow rather than for short-term trading gains.
- Fair value information for financial instruments is considered relevant and valuable by most respondents but is not necessarily the key consideration in their analysis of an entity. It is used in a variety of ways by respondents, but usually as they form their views on an entity's liquidity or capital adequacy or in an enterprise value calculation. It is seldom used as an indicator of future cash flow generation.

Clearly, the FASB stands alone in believing that fair value reporting alone provides accurate, meaningful, and useful financial reporting for investors, management, and members/customers. In the Leagues' view, the opposite is true, and the proposal must be withdrawn in order to make it more realistic, manageable, and harmonious with other accounting bodies' reporting models.

Thank you for the opportunity to share our views on this proposal. We appreciate your consideration of our comments, and urge the FASB to recognize that a more reasonable and viable framework for financial instruments reporting is needed than what has been proposed.

Sincerely,

David L. Chatfield Interim President/CEO

California and Nevada Credit Union Leagues