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April 4, 2011

Via e-mail

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

RE: FASB File Reference No. 2011-150 *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment*

Dear Ms. Cosper:

The Federal Housing Finance Agency (FHFA) welcomes the opportunity to comment on the above-referenced due process document pertaining to impairment of financial instruments (the proposal). As the regulator of the Federal Home Loan Bank System, and the regulator and conservator of Fannie Mae and Freddie Mac, we are deeply interested in improving accounting and disclosure for financial instruments, including loans and financial guarantees. Financial regulators look to transparent financial statements based upon generally accepted accounting principles (GAAP) to promote market discipline for the entities they regulate. The recent turbulent economic times and troubled credit markets revealed that some entities reporting under existing GAAP failed to timely reflect the financial impacts of events on their financial performance and condition. With some enhancement, the proposal has the potential to significantly improve the timely recognition of credit losses in financial statements.

Summary

FHFA supports moving from the incurred loss model to an "expected loss" approach, to help ensure that expected credit losses are recorded timely and are fully disclosed. FHFA supported the original FASB proposal because it provided for timely recognition of all initially expected credit losses with changes recognized when they were identified.[1] We understand that this approach is balance sheet-focused and did not necessarily try to proportionately match expected credit expenses with expected revenues. We also understand that some thought the original Financial Accounting Standards Board ("FASB" or "Board") proposal provided reserves "too

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[1] Please see FHFA's comment letter File Reference No. 1810-100, Comment Letter No. 1433, in which we expressed our support for: ". . . a single credit impairment model for all financial assets based on expected loss. However, we encourage the Board to permit the use of reasonable and supportable economic forecasts …".

much, too soon." As explained below, we believe that with some adjustment, the common proposal could present an opportunity to reach a reasonable compromise that would improve the current reporting model. Following are the key points FHFA requests the Board to consider. Please see the attached appendix for a more detailed discussion.

1. **Foreseeable future** - FHFA recommends that the "foreseeable future" be defined to encompass most of the expected lifetime losses including changes in forecast losses subsequent to day-one due to changed economic conditions. We are concerned that the presently-specified minimum time period of 12-months may encourage entities to adopt relatively short foreseeable future time periods which would result in not solving the "too little, too late" problem. As explained in the appendix, widely-used products such as single family mortgage loans have expected lives far longer than one year. Therefore, we recommend that the final standard not include a "bright-line," in favor of a foreseeable future definition that would ensure that longer periods of time would be incorporated where appropriate. In particular, we favor a definition that will require a reporting entity to arrive at a time period for forecasting expected losses that would capture in the estimate most of the costs related to defaults expected over the remaining life of the portfolio, similar to the present mortgage-backed security (MBS) impairment model, mentioned below. (If this is done, we note that the time-proportionate component of the common proposal would only be necessary in limited circumstances.)

2. **Good book-bad book** – FHFA supports the "good book-bad book" concept. We believe it will provide an improved calculation methodology as well as a good basis to provide better disclosure of credit quality. However, we believe a more robust definition of how to classify loans in the good book–bad book format would be required to minimize diversity in practice. For a loan portfolio, where credit risk is managed on a pooled basis, the good book-bad book segregation may not be necessary to accomplish a robust reserve calculation because typical credit reserving models can appropriately address the reserve calculation for loans with different characteristics and financial condition. With good models and a robust definition of "foreseeable future," lifetime expected losses on "bad book" loans could be captured regardless of which book they are in. However, if the final standard permits some entities to adopt short foreseeable future periods, e.g., 1 – 2 years for single family mortgage-related assets, the bad book concept would be necessary for robust reserve calculations and could also be informative as a basis for disclosure of credit quality.

3. **Single impairment model** – FHFA continues to support a single converged credit impairment model for all financial assets accounted for on an amortized cost basis. In particular, we would prefer that the Board implement the same impairment model for portfolios of loans and securities, loan commitments and financial guarantees:

   Debt Securities - It is not clear how the common proposal would apply to securities, including MBS which share risk characteristics with their underlying loans. That said, we also note that the common proposal, no matter how it might be applied to debt securities, is different than the present US GAAP model used for impairment of debt securities (adopted in April 2009) in that the present model calls for calculation of impairment on the basis of the expected life of the portfolio through to resolution of the collateral. FHFA believes that the present impairment model for investments in debt securities is based upon sound financial and economic concepts and has proven

operational for securitized pools of loans in MBS, and therefore would be well-suited to mortgage loans. Further, the debt securities model is reconcilable with both fair value and amortized cost presentations.

Financial guarantees - For financial guarantees that are not currently accounted for as derivative instruments, we understand that the FASB has not yet decided on whether these contracts should be accounted for as insurance contracts or financial instruments. We believe it would be most desirable to ensure that the balance sheet of a company reflects the current fair value of the financial guarantees at the end of each reporting period. Accordingly, our first preference would be for the Board to require that all financial guarantees be accounted for the same way as derivative instruments (i.e., measured initially and subsequently at fair value with changes in fair value recognized in net income). Because of their highly variable contractual cash flows, we believe fair value would be the only appropriate measurement basis on which to account for financial guarantee contracts. However, if the Board elects to allow financial guarantees to be measured at amortized cost, we recommend that the Board require the application of the same expected loss-based credit impairment model as it mandates for other financial instruments.

Loan commitments – Loan commitments have the same risk characteristics as loans and, therefore, the accounting treatment should be parallel. Similar to financial guarantees, our first choice would be for them to be accounted for at fair value. But, for any loan commitments the Board decides to account for at amortized cost or FV-OCI (i.e., at fair value, with certain changes in fair value recognized in other comprehensive income), we would like the Board to require the application of the same credit impairment model as for the related type of loan classification.

4. **Time schedule** - There are significant conceptual differences between the earlier FASB and IASB (the "Boards") proposals and the newer common proposal. Along with other significant standards-setting activities, it appears the subsequent announced milestones may be too imminent to facilitate the broad and careful consideration and comment this proposal deserves. We understand that the Boards have committed to complete the final guidance on credit impairment for financial instruments by June 2011, but we would hope that the Boards do not sacrifice the quality of the final guidance for the sake of meeting the committed deadline.

Thank you for the opportunity to provide our views. If you have any questions or comments regarding this letter or wish to enlist FHFA's further participation, please contact me at 202-343-1832 or Nicholas.satriano@fhfa.gov.

Sincerely,

Nicholas J. Satriano, CPA
Chief Accountant

Appendix

ANSWERS TO QUESTIONS

FASB File Reference No. 2011-150 *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment*

Question 1:

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (i.e., delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

Response to Question 1:

Our response to this question is in three parts: (1) foreseeable future, (2) good book-bad book, and (3) single impairment model.

Foreseeable future:

As presently proposed, the "foreseeable future" definition may result in reserves which do not capture the majority or even a significant portion of total expected credit losses, as of the calculation date. In particular, the specification of a 12-month minimum suggests that one or two years may be an acceptable capture period. FHFA believes that the ideal "foreseeable future" would capture all expected default-related costs, through to resolution of the collateral. Recognizing that this could result in "too much, too soon" in the eyes of some, we believe as a reasonable compromise position that the definition should be revised to require capture of a "majority of the costs of default, through to resolution of the collateral," as explained below. Further, under some circumstances a minimum, such as the proposed time-proportionate minimum feature of the common proposal, could be useful to preclude under-reserving.

Mortgage loan portfolios and mortgage-backed securities often have expected lives of seven to eight years, although they can last longer. Most defaults occur or are identified as probable during the first five years. Risk of loss does not cease with foreclosure as further losses may continue until the collateral is sold. These losses may be significant and the post-foreclosure risk exposure may extend for two or three years. Post-foreclosure costs include real estate owned operating costs (e.g., taxes, insurance, home owner association fees) and lower-of-cost-or-market write-downs of the collateral's fair value. Holding large amounts of non-revenue producing assets in a falling real estate market entails significant carrying costs and exposure to price risk.

Because of all of these factors, a "foreseeable future" of three years or less, for some products, would enable a reserve methodology that would not capture even a bare majority of expected costs related to default. Currently, it can take two years to bring a seriously delinquent loan to foreclosure and two more years to liquidate the collateral. Therefore, we believe that five years *may* be adequate, but seven to eight years would be preferable for single family mortgage-related products. However, given the variety of products in the market with varying time horizons, rather than pick a "bright line," FHFA believes it would be simpler (as well as principles-based) to specify in the standard that "foreseeable future" should approximate the expected life of the

particular portfolio. And, as mentioned above, we would also suggest that the FASB incorporate post-foreclosure costs into the reserve requirements for loans, because these costs can be significant and their inclusion would bring the methodology for loan-related losses into line with the methodology presently used for impairment of mortgage-backed securities. In conclusion, we recommend that the test of adequacy of implementation of the standard should be whether the calculation captured the majority of expected default-related costs over the remaining expected lifetime of the portfolio, through to resolution of the collateral, as of the calculation date.

Good book-bad book:

FHFA supports the "good book-bad book" concept. We believe it will provide an improved calculation methodology as well as a good basis to provide better disclosure of credit quality. However, we believe a more robust definition of how to classify loans in the good book–bad book format would be required to minimize diversity in practice. For a loan portfolio where credit risk is managed on a pooled basis, the good book-bad book segregation may not be necessary to accomplish a robust reserve calculation because typical credit reserving models can appropriately address the reserve calculation for loans with different characteristics and financial condition. Moreover, properly administered and with realistic and valid assumptions, a robust definition of "foreseeable future" lifetime expected losses on "bad book" loans could be captured by a good model, regardless of which book they are in. However, if the final standard permits some entities to adopt short foreseeable future periods, e.g., one to two years for single family mortgage-related assets, the bad book concept would be necessary for robust reserve calculations and could also be informative as a basis for disclosure of credit quality. Finally, it is unclear how in this context diversity in practice and significant movement between the books would be addressed.

Single impairment model:

FHFA continues to support a single converged credit impairment model for all financial assets accounted for on an amortized cost basis. In particular, we would prefer that the Board implement the same impairment model for portfolios of loans and securities, loan commitments and financial guarantees:

> **Debt Securities** - It is not clear how the common proposal would apply to securities, including MBS which share risk characteristics with their underlying loans. That said, we also note that the common proposal, no matter how it might be applied to debt securities, is different than the present US GAAP model used for impairment of debt securities (adopted in April 2009) in that the present model calls for calculation of impairment on the basis of the expected life of the portfolio through to resolution of the collateral. FHFA believes that the present impairment model for investments in debt securities is based upon sound financial and economic concepts and has proven operational for securitized pools of loans in MBS, and therefore would be well-suited to mortgage loans. Further, the debt securities model is reconcilable with both fair value and amortized cost presentations.
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> **Financial guarantees** - For financial guarantees that are not currently accounted for as derivative instruments, we understand that the FASB has not yet decided on whether

these contracts should be accounted for as insurance contracts or financial instruments. We believe it would be most desirable to ensure that the balance sheet of a company reflects the current fair value of the financial guarantees at the end of each reporting period. Accordingly, our first preference would be for the Board to require that all financial guarantees be accounted for the same way as derivative instruments (i.e., measured initially and subsequently at fair value with changes in fair value recognized in net income). Because of their highly variable contractual cash flows, we believe fair value would be the only appropriate measurement basis on which to account for financial guarantee contracts. However, if the Board elects to allow financial guarantees to be measured at amortized cost, we recommend that the Board require the application of the same expected loss-based credit impairment model as it mandates for other financial instruments.

Loan commitments – Loan commitments have the same risk characteristics as loans and, therefore, the accounting treatment should be parallel. Similar to financial guarantees, our first choice would be for them to be accounted for at fair value. But, for any loan commitments the Board decides to account for at amortized cost or FV-OCI (i.e., at fair value, with certain changes in fair value recognized in other comprehensive income), we would like the Board to require the application of the same credit impairment model as for the related type of loan classification.

Question 2:

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the Boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

Response to Question 2:

Due to changing portfolio composition of the open portfolio, calculating credit impairment for open portfolios appears to be the greater operational challenge, compared to closed portfolios. Therefore, FHFA believes that any proposal which is workable for open portfolios would be at least as workable for closed portfolios.

FHFA believes that the same impairment approach should be used for all financial assets with similar credit or cash flow characteristics. In particular, impairment of individual assets or asset portfolios should be based upon the same methodology as securities collateralized by the same assets. As discussed in our response to question #1, FHFA believes that the existing credit impairment model for investment securities (as we see it applied to MBS) is sound, economically valid, and could work well for mortgage loans. We recognize that others feel that this approach might result in reserving "too much, too soon," however, we do not share this view.

Question 3:

Do you agree that for financial assets in the "good book" it is appropriate to recognize the impairment allowance using the approach described above? Why or why not?

Response to Question 3:

Please see our response to question #1 where we discuss why an expansive definition of foreseeable future is needed to capture a majority of expected losses through to resolution of the collateral.

Question 4:

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

Response to Question 4:

FHFA believes that the time-proportional approach should be operational given the capabilities of modern IT systems. However, we believe that the responses of preparers should be given more weight than regulators in this connection. As noted above in our response to question #1, under some circumstances a minimum, such as the proposed time-proportionate minimum feature of the common proposal, could be useful to preclude under-reserving.

Question 5:

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

Response to Question 5:

FHFA believes that the proposal would provide useful information for decision-making as well as disclosure. However, refinements could be made to increase usefulness as we suggested in our response to question #1.

Question 6:

Is the requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Response to Question 6:

FHFA believes that diversity in practice would likely result from the current description. However, diversity could be reduced if the definitions were enhanced with more context and examples. In this regard, FHFA suggests that a simple definition be established as the criteria. This would make the definition more operational and reduce diversity across a variety of

institutions. Robust disclosure of the rationale behind management's good book-bad book classification would also provide transparency for users of the financial statements.

Question 7:

Is the requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

Response to Question 7:

So long as clear criteria are used, the two-book approach would be operational and auditable.

Question 8:

Do you agree with the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

Response to Question #8:

Please see our response to question #1. Essentially, we believe this breakdown would enhance the calculation process by making it more difficult for entities to avoid providing a full allowance on "bad" loans.

Question 9:

The Boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?

Response to (a) We agree with the general concept of a "floor" in order to assure that there will always be enough reserves to cover the charge-offs.

(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?

Response to (b) A floor would be helpful wherever losses are not expected to occur on a straight line basis.

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

Response to (c) Please see our response to question #1.

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

Response to (d) It should be expected that, in more stable times, longer forecasts can be reliably made and, therefore, foreseeable future could be longer in stable times. Lifetime expected cash flows would change if significant changes were expected in economic conditions.

(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.

Response to (e) For the firms that FHFA regulates, the "foreseeable future," necessarily, is the total expected lifetime of the financial instrument, which is longer than 12 months. The lifetime view is necessary in order to set guarantee fees appropriate to the lifetime risk of the product.

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognized under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Response to (f) FHFA does not believe that a ceiling would be appropriate. We believe that expected losses should be provided for as soon as they are identified.

Question 10:

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

Response to Question 10:

For residential mortgages, the majority of defaults occur within the first five years after loan origination. That is, the defaults are front loaded. A floor would act to assure provision is sufficient to cover early charge offs.

Question 11:

The Boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?

Response to (a) - FHFA believes that for long-lived products, discounting should be required. For purposes of comparability, discounting should be done consistently by all preparers, i.e. discounting should be required for all entities, or not required for any.

(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

Response to (b) - If discounting is to be mandated, then for comparability and to avoid unnecessary diversity of result, the type of discount rate should be. At a minimum, we recommend a risk-free rate, e.g., LIBOR, Treasury. Otherwise, comparability will suffer across institutions.

Question 12:

Would you prefer the IASB approach for open portfolios of financial assets measured at amortized cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (i.e., to recognize expected credit losses over the life of the assets)? Why or why not?

Response to Question 12:

FHFA does not believe that amortizing expected credit losses to provide reserves over the life of a portfolio of assets is advisable because for many assets, credit losses are experienced on a front-loaded basis. Therefore, time proportional provisioning may fail to provide reserves fast enough to cover needed charge-offs. The "floor" of the common proposal will be necessary to assure sufficient reserves to cover charge-offs unless an expansive approach to defining "foreseeable future" is taken, as discussed above.

Question 13:

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (i.e., to recognize currently credit losses expected to occur in the foreseeable future)? Why or why not?

Response to Question 13:

FHFA believes that the initial FASB proposal (modified to permit reasonable and supportable forecasts) is preferable to the common proposal, because of its immediate recognition of all total expected losses and, further, because there would always be sufficient reserves for any charge-offs.