

May 21, 2013

Ms. Leslie Seidman Chairman Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: Financial Instruments – Credit Losses (Subtopic 825-15)

Dear Ms. Seidman:

The Global Financial Institutions Accounting Committee of the Securities Industry and Financial Markets Association (SIFMA)<sup>1</sup> appreciates the opportunity to provide comments on the FASB's Proposed Accounting Standards Update, *Financial Instruments – Credit Losses (Subtopic 825-15)* (the "Proposed Update" or "ASU").

While SIFMA recognizes the need for a high quality impairment accounting standard which would provide financial statement users with relevant, reliable and more decision-useful information through more accurate loss provisioning, a majority of our members do not support the overall credit loss approach in the Proposed Update based upon our concern regarding the requirement to estimate credit losses over the entire contractual term of financial assets. Recognizing credit losses based on the full contractual term at inception does not accurately reflect in the accounting records an entity's economic credit risk exposure on day one. When financial institutions issue loans or purchase financial instruments, the expected initial credit losses are already taken into consideration when pricing the instrument at inception. Therefore, recording a provision for expected credit losses on day one (under the IASB and especially under the FASB model) would result in an earnings mismatch as interest revenue is recognized over the life of the instrument.

As an alternative to the proposed approach of using the entire contractual term, the majority of SIFMA members believe that using the foreseeable future instead would provide a more reasonable and decision useful estimate of expected credit losses.

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<sup>&</sup>lt;sup>1</sup>SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit <a href="https://www.sifma.org">www.sifma.org</a>.

Foreseeable future as a forecast horizon represents a forecast period over which expected credit losses can be reasonably estimated.

If the Board disagrees with our suggestion to use the foreseeable future to measure expected credit losses and decides to retain the requirement to use the entire contractual term as a forecast horizon for estimating future expected credit losses, the concerns we would like to bring to the Board's attention include the following:

- Although the Board recognized in the proposal that expected prepayments may affect the allowance for expected credit losses, we believe that the term "entire contractual term," as currently used in paragraph 825-15-25-3 of the Proposed Update, should be modified to clarify whether an entity should determine expected credit losses using contractual maturity or maturity based on the expected life of a financial asset (or group of financial assets) that would consider expected prepayments. To eliminate such ambiguity, the Board should include within the Glossary section of the proposal a term that properly defines the period over which expected credit losses are to be measured.
- The Board should include an illustrative example of how an entity should go about determining the expected maturity for revolving credit facilities, demand notes, and loans and lending commitments with annual contractual renewal provisions.

Regarding the overall proposed credit loss model, a majority of our members recommend that:

- The current other-than-temporary impairment (OTTI) model, with some suggested modifications, be retained for financial instruments measured at FV-OCI and the revised CECL model be applied to those measured at Amortized Cost;
- Instruments classified in FV-OCI be exempt from the proposed non-accrual guidance;
- The Board should characterize existing credit loss estimation methods as acceptable alternatives, rather than as methods that implicitly reflect the time value of money (TMV); and
- The classification of a Troubled Debt Restructuring (TDR) be eliminated and all debt restructurings, troubled or non-troubled, be accounted for under the same accounting principle for debt extinguishment and modification. However, we would support providing disclosures about restructured financial assets.

#### Furthermore, we ask that:

- Short-dated and/or collateralized receivables subject to margining be excluded from the scope of the Proposed Update;
- The Board clarify the terms "significant deterioration" in credit quality and "insignificant" credit losses as used in the criteria for Purchased Credit-Impaired (PCI) assets and the practical expedient, respectively; and
- The FASB consider the impact this proposal will have in relation to the disclosure framework project, which aims to streamline disclosures, before proceeding with the new disclosures. We are concerned about the volume of additional information being requested in the Proposed Update as the required

information will not always be readily available from existing systems and building new systems is required to provide data that has limited benefit to the users of the financial statements.

A minority of our members support the adoption of the IASB model as they believe it more accurately reflects the economics of a lending relationship and is therefore a better and more reliable measurement for financial instruments. Those same minority members also believe that the FASB and the IASB need to converge to the same impairment standard to promote comparability among issuers.

Appendix A includes a more detailed discussion of the above and additional points on the Proposed Update.

We thank you for the opportunity to provide our industry view. The Global Financial Institutions Accounting Committee would be pleased to discuss our response with the FASB staff. Please contact me at 212-357-8437 if you have questions or comments concerning our letter.

Regards,

Matthew L. Schroeder

Matt Schooler

Chairman, SIFMA Global Financial Institutions Accounting Committee

Copy to:

Paul Beswick, Chief Accountant, Office of the Chief Accountant, SEC Susan Cosper, Technical Director, FASB Steven Kane, Project Manager Mary Kay Scucci, PhD, CPA, Managing Director, SIFMA

#### APPENDIX A

# **Time Horizon for Estimating Credit Losses**

SIFMA recognizes that the foundation of a high quality impairment accounting standard ought to balance accurate loss provisioning with providing financial statement users with relevant and decision-useful information. Most SIFMA members are concerned with the requirement to estimate credit losses over the entire contractual term of financial assets. Furthermore, recognizing full credit losses based on the contractual term of the instrument at inception does not accurately reflect in the accounting records an entity's economic credit risk exposure on day one. When financial institutions issue loans or purchase financial instruments, the credit losses that are initially expected are already priced into the instrument. Therefore, recording an allowance for additional expected credit losses on day one would double count these initial credit losses while interest revenue generated by the financial instrument is recognized only when time passes until the instrument approaches maturity.

As an alternative, a majority of SIFMA members are proposing to use "foreseeable future," which includes a far more reasonable and supportable forecast horizon and would produce a more relevant and decision useful estimate of expected credit losses than full contractual life. While the term foreseeable future is already used in U.S. GAAP (including, for example, with respect to loans and trade receivables measured at amortized cost that are not held for sale, which "management has the intent and ability to hold for the foreseeable future or until maturity or payoff...." (ASC 310-10-35-47), the members who support this concept believe it should be defined as a forecast period over which expected credit losses can be reasonably estimated. However, entities will need to evaluate the foreseeable future time horizon for each type of asset depending on the nature of a particular credit exposure (e.g., whether it is a wholesale, retail, mortgage or corporate exposure, and whether dealing with a term versus a revolving facility). Therefore, entities should be allowed to define the foreseeable future at the We also suggest that the Board require disclosures of such asset-class level. information in order to facilitate comparability among various entities.

If the Board disagrees with our suggestion to use foreseeable future and decides to retain the proposed forecast horizon, the term "entire contractual term" needs to be clarified. Although the Board recognized in the proposal that expected prepayments may affect the allowance for expected credit losses, we believe that the term "entire contractual term," as currently used in paragraph 825-15-25-3 of the Proposed Update, would result in a lack of clarity as to whether an entity should determine expected credit losses based on contractual maturity or *expected* maturity that is based on the expected life of a financial asset (or group of financial assets) that considers expected prepayments.

To eliminate any ambiguity as to the Board's expectation with respect to the forecast horizon, the Board should include within the Glossary section of the Proposed Update a term that properly defines the period over which expected credit losses are to be measured.

The Board should also include an illustrative example of how an entity should go about determining the expected maturity with respect to revolving credit facilities, demand notes, and loans and lending commitments with annual contractual renewal provisions.

## Credit Impairment Model for Instruments Classified in FV-OCI

We believe that the current guidance, contained in ASC 320-10 and referred to as the Other-Than-Temporary-Impairment model, or OTTI, is a better approach for recognizing credit impairment for debt securities than the proposed CECL model along with the practical expedient for not recognizing insignificant expected credit losses. The current OTTI model for debt securities is well understood, operational and has been applied consistently. However, we do not advocate a separate credit impairment model just for debt securities. Therefore, we propose that the FASB consider aligning the credit impairment models to the measurement categories per the proposed ASU, Financial Instruments – Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities, as follows:

- The current OTTI model (with the modifications described below) should apply to financial instruments, including debt securities and loans, measured at FV-OCI (refer to the next section below regarding our recommendation that the non-accrual concept should not apply to instruments measured at FV-OCI).
- However, the FASB should modify the current OTTI model to allow the OTTI evaluation to be performed on a pool of assets as well as on an individual asset basis. Such a modification would help to better accommodate the application of this model to loans, which are often accounted for on a pool basis.
- As another modification, the OTTI model should allow increases in expected cash flows to be recorded in earnings similar to decreases today. This symmetrical treatment of gains and losses would make the OTTI model consistent with the recognition increases and decreases of expected cash flows as credit loss allowance adjustments under the proposed CECL model.
- The revised CECL model should apply to all financial assets measured at Amortized Cost.

If the FASB rejects our suggestion to adopt the current OTTI model for financial instruments measured at FV-OCI, we are asking the FASB to change the proposed practical expedient by eliminating the first criterion allowing expected credit losses not to be recorded when the fair value of the instrument is greater than (or equal to) the amortized cost basis of the financial asset. Instead, we would support the second criterion that entities may elect not to record insignificant credit losses, but would have to record credit losses that are expected to be more than insignificant regardless of whether the fair value of the asset is above or below the amortized cost.

#### Applicability of Non-accrual Concept

We believe that the proposed non-accrual guidance is not necessary for debt securities. Impairment of a debt security is typically measured based on the present value of expected cash flows, discounted at the security's effective interest rate. Recognition of interest income is necessary in order to accrete the amortized cost basis of the debt security to the cash flows expected to be collected. Application of the proposed non-accrual guidance is redundant for debt securities as the impairment measurement

already excludes the contractual cash flows that an entity does not expect to collect. Accordingly, placing a debt security on non-accrual status would be misleading as interest income would either be deferred until sale or maturity, or recognized at a rate that differs from the security's effective interest rate. Application of the non-accrual guidance would significantly change current practice for income recognition for impaired debt securities. However, we do not advocate a separate non-accrual guidance for debt securities measured at FV-OCI and thus recommend that the nonaccrual concept should not be applicable to any instrument in that category. Because these instruments are measured at fair value, any interest accrued is carved out of periodic mark-to-market movements recognized in OCI and instead is recognized as interest in the income statement and ultimately as retained earnings. For risk-based capital ratio purposes we do not see the benefit of a non-accrual concept for instruments measured at FV-OCI, since if interest could not be accrued, the full markto-market would be recorded in OCI. Thus, the only impact of classifying a FV-OCI asset as non-accrual is the line item within comprehensive income in which this carved-out amount is recognized.

Most of our members support retaining the non-accrual concept at least for loans classified in amortized cost, since users find this concept helpful in evaluating a bank's loan portfolio.

# **Time Value of Money**

A majority of SIFMA members do not support the FASB's inclusion of a time value of money ("TVM") principle in the proposed credit loss model.

The TVM principle implies the ability to:

- Forecast the timing of losses
- Forecast the timing of recoveries
- Discount charge-offs and recoveries back to the date of the loss (e.g., default date)

Because of the arbitrary nature of these time estimates, the TVM concept is not present in current credit loss estimation calculations except for impaired loans (per ASC 310-10). The members not supporting the TVM concept do not believe that any company would be able to estimate the timing of these events with any measure of accuracy. While we agree that TVM is inherent in the amortized cost measurement and that estimating a loss by referencing the amortized cost measurement therefore inherently reflects some discounting, since timing of expected losses is not built into current credit loss estimation models, we are concerned that the inclusion of the TVM principle will result in interpretive risk to preparers without providing real practical benefit to the financial statement users.

In addition, the inclusion of a TVM principle will not keep credit losses and yields separate as desired by users and preparers of financial statements alike. The allowance and provision will experience volatility unrelated to credit risk based purely on the time value of money. We do not anticipate this volatility being easily understood by users of financial statements. This volatility is evident in the following situations:

- If credit loss estimates come true as expected, the allowance will be relieved through charge-offs for principal losses and provision releases (akin to a "yield") for interest losses.
- The current relationship between allowance levels, charge-offs and changes in portfolio credit risk will be broken by the inclusion of unrelated TVM volatility.
- When loans unexpectedly go on non-accrual status, there will be a large increase to the allowance for lost interest, only to be reversed back through the provision over time. This "yield" earned from the allowance being released through the provision seems inconsistent with ceasing the interest accrual in the first place.
- Holding other factors constant, the allowance will increase over time as loans age and fewer interest payments are due.
- Holding other factors constant, the allowance will decrease over time for non-accrual loans as the principal payments come closer to their due dates.

For both users and preparers, the volatility resulting from these TVM impacts will be very difficult to analyze and isolate from credit risk changes across large portfolios. We simply do not believe that the theoretical purity of a model that incorporates TVM is worth the practical problems that it introduces.

At a minimum, we believe the FASB should characterize current credit loss estimation methods as "acceptable alternatives" to approximate the present value under a discounted cash flow model, rather than as methods that implicitly reflect the time value of money. Also, we ask that the FASB include in the ASU language similar to that in the Q&A document (Proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)*-Frequently Asked Questions, *March 25, 2013*), which explains that "An entity would not be required to prove that a method that *implicitly* reflects the time value of money (as described in paragraph 825-15-55-3 of the proposed Update on credit losses) provides the same result as (or reconciles with) a method that *explicitly* reflects the time value of money." Since the inclusion of TVM makes several assumptions that are not present in current credit loss estimation processes, we are concerned that without such characterization of current credit loss methods as acceptable alternatives and explicit guidance not having to reconcile the credit loss estimates, auditors will require preparers to substantiate the FASB's assertion that current methodologies implicitly reflect the time value of money.

#### **Elimination of the TDR Classification**

A majority of SIFMA members do not support the FASB's retention of a special classification for troubled debt restructurings (TDR). We believe that the concept of TDR that requires a direct write-off is no longer relevant under the proposed credit loss model. In current practice, many of our members already consider debt forgiveness or concession of contractual terms to be a loss that results in a charge-off. This practice is expected to be reflected as a basis adjustment to the carrying value of the loan under the proposed credit loss model. When there are significant modifications and related write-offs on the loans, the lender should be viewed as granting a new loan under a new set of contractual cash flows. Accordingly, we are of the view that under the

proposed credit loss model, a TDR should not be accounted for differently from any other debt restructurings. To distinguish a TDR from other non-troubled debt restructurings creates an exception to the general standard of debt modification and extinguishment. This would not be consistent with the spirit of principles-based accounting and is also operationally burdensome for institutions without adding any perceivable benefits. Therefore, we recommend that the TDR classification be removed and all debt restructurings, troubled or non-troubled, be accounted for under the same accounting principle for debt extinguishment and modification. Furthermore, removal of the TDR classification will eliminate another divergence between U.S. GAAP and IFRS.

We agree that significant debt restructuring activities are expected to be of interest to the users of financial statements and, therefore, suggest that such actions should continue to be included in the required disclosures for significant debt/loan restructurings.

# Scope Exceptions for Short-Dated and/or Collateralized Receivables Subject to Margining

The broad scope of the Proposed Update includes short-dated and/or highly collateralized receivables subject to daily margining. These receivables are generally carried at values that approximate fair value, for which the historical practice of recognizing losses when incurred is well understood by preparers and users. As described below, we believe a scope exception for such receivables is necessary for conceptual and operational reasons. These types of receivables were not the subject of the Board's review of the current impairment model for loans and debt securities and, in our view, should continue to be subject to the impairment requirements of ASC 450.

Conceptually, the CECL model requires a credit loss to be recognized for all receivables, even when the expectation of loss for all practical purposes is close to zero. Therefore, a reserve would be required to be calculated for these receivables based on potential loss scenarios with a very low probability of occurring. While we don't expect the application of the CECL model to result in a significant increase in recognized reserves for these types of receivables, it will be operationally burdensome to apply and will result in additional reserves that would not be supportable based on historical experience or even reasonably forecasted scenarios in the foreseeable future. The following are examples of short-dated and/or highly collateralized receivables subject to margining that, in our opinion, should not be subject to the proposed model:

- Margin Lending and Reverse Repurchase Agreements are typically fully collateralized receivables that are generally short dated and are collateralized by financial instruments. Credit risk is mitigated through collateral monitoring on a fair value basis and daily margining. Loss experience on such receivables, if any, is generally the result of operational errors rather than the inability to collect all amounts due.
- Trade Date and Fail-to-Deliver receivables are generated by selling of securities that settle in a regular way market, generally within 3 days. These receivables are measured initially at the selling price of securities sold, including any

- accrued interest. The receivable is fully collateralized by the securities to be delivered and therefore there are no expected credit losses.
- Receivables for the right to reclaim cash collateral posted against derivative payables, while not measured on a fair value basis, are reported at amounts that approximate fair value due to daily margining based on the changes in fair value of the related derivative. Additionally, collateral terms are also taken into consideration in the fair valuation of derivatives. Subjecting cash collateral receivables to the CECL model will result in double counting of potential credit losses.
- Accounts receivable, for which the incurred loss model already captures the life of instrument loss estimate.

# Significant vs. Insignificant Deterioration in Credit Quality

Qualification for accounting for a purchased financial asset as "purchased creditimpaired" (PCI) is dependent upon whether or not that asset has had "significant deterioration" in credit quality since origination. We ask for a clarification of the term "significant deterioration" in credit quality for purchased credit-impaired financial assets versus "insignificant" deterioration. The distinction between "significant" and "insignificant" expected credit losses is also key to determining the eligibility for the practical expedient and some insight about how the Board thinks about these terms would be helpful.

Understanding their meaning is important because depending on the interpretation of significant deterioration, the interest income recognition and credit loss allowances will differ for PCI vs. non-PCI financial instruments. Furthermore, if a purchased non-PCI financial instrument is classified in FV-OCI, depending on whether the expected credit losses are deemed to be insignificant, companies will need to determine whether the practical expedient not to recognize expected credit losses would apply to such instruments.

Additionally, while we agree that at least conceptually there should be a single definition for significant deterioration in credit quality for loans and debt securities; there are difficulties in practice to operationalize its application for debt securities compared with loans.

#### Disclosures

We agree that the financial statements should include information that enables users to understand the credit risk that a financial institution faces and how it manages the risk, and that many of the proposed disclosures meet this need, provided that these do not duplicate existing disclosures. We believe that the best way to provide investors with relevant and reliable information is to base the disclosures on information used by management to manage the risk that is tailored to the nature of the portfolios of debt instruments, including distinguishing between loans and debt securities, which we believe is consistent with paragraphs 825-15-50-4 and 825-15-50-5 of the proposed Update.

However, the proposed FV-OCI disclosures are loan-based not security-based, and will be less useful to users of financial statements than the current disclosures for AFS securities, given the not infrequent portfolio asset/liability repositions for these securities.

We are concerned about the volume of additional information being requested in the Proposed Update. In some cases, the required information will not be readily available from existing systems and will require a significant effort to build systems to provide data that has limited benefit to the users of the financial statements – in particular, the roll-forward of the entity's debt instruments in paragraphs 825-15-50-12 and 825-15-50-13, which is of limited value in terms of disclosing information about the credit quality of an entity's financial assets and better obtained from information provided through the proposed credit quality disclosures.

We recommend that the FASB consider the impact this proposal will have in relation to the disclosure framework project, which aims to streamline disclosures, before proceeding with the new disclosures.

# **Transition**

While we support the proposed transition, we believe that constituents need considerable time to be able to adopt the standard and provide the additional disclosure required by the standard. Furthermore, we suggest aligning the implementation time period with the Proposed Accounting Standards Update—Financial Instruments (Subtopic 825-10)—Recognition and Measurement of Financial Assets and Financial Liabilities as this proposal is interrelated to that Proposed Update. As these proposals are expected to be implemented during the same time period as other significant new proposals such as Proposed Accounting Standards Update—Revenue Recognition (Topic 605): Revenue from Contracts with Customers—Proposed Amendments to the FASB Accounting Standards Codification and Proposed Accounting Standards Update—Leases (Topic 840), we would support an effective date which is a minimum of three (3) full years from the issuance of the final Accounting Standards Update.