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FASB Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5166

Proposed Accounting Standards Update, Financial Instruments—Credit Losses (Subtopic 825-15) File Reference No. 2012-260

#### Dear Director:

Auriemma Consulting Group (ACG) is a boutique management consulting firm focused on the payments and lending arena that has been advising financial institutions, retailers, capital markets participants and other interested parties since 1984. Our roots are in the credit card lending business, but we now consult in all forms of consumer lending and payment technology.

Since 1992, ACG has hosted The Accounting Forum (TAF) that is comprised of senior accounting policy personnel from many of the major US credit card issuers. The group's members currently represent card issuing banks with an aggregate of nearly \$400 billion in credit card receivables and total annual purchase or transaction volume of nearly \$3.5 trillion. The main activity of TAF is to promote understanding and best practices with regard to accounting policy and related finance and treasury matters for the credit card industry. To this end, over the past two years, TAF has also had the benefit of hearing from FASB on emerging issues and we place a high value on these discussions.

For over 20 years, major credit card issuers have regularly come together at TAF to discuss accounting rule changes and proposed changes. TAF is an undiluted voice for the credit card industry and, as such, we feel a particular obligation to provide comments on the Proposed Accounting Standards Update 825-15, Financial Instruments – Credit Losses (The Proposal). We understand that The Proposal affects all financial institutions, but the credit card industry is an important segment with unique business procedures. Accordingly, our letter reflects the consensus positions of our members.

ACG would first like to acknowledge the important work of the FASB. We recognize the impetus to address shortcomings in today's incurred loss model that were revealed during the recent financial crisis. There has been much criticism of the lack of transparency at large financial institutions as well as a general belief that most lenders had not adequately reserved for the credit risk in their financial instruments portfolios. We understand and agree that it is imperative for the measurement of credit risk and the allocation of loan loss reserves to be clear and understandable to users of financial statements; it is in this context that we wish to discuss several topics addressed in The Proposal.

### Lifetime Loss Calculations for Credit Cards

Credit card loans or "receivables" are created pursuant to an agreement between a credit card issuing bank and an individual. The agreement between the issuer and the consumer is an "account" and contains the terms under which credit is extended to the consumer. As a result of the flexibility afforded to the consumer under typical credit card account terms, the calculation of the "life" of an individual receivable becomes quite problematic. Consumers have a choice of paying an outstanding balance in full (a "transactor") or of paying a minimum payment, calculated

as a function of the total account balance each period, or of paying an amount in between the minimum and the full balance (a "revolver"). Since there is no set contractual payment required, but rather a range of optional payments, calculating the life of a credit card receivable is very challenging. Minimum payments are calculated based on the total outstanding receivable balance each month. While each consumer purchase under a credit card is an incremental extension of credit, consumers tend to view the aggregate balance as the "loan" amount rather than a series of individual loans. Consumers making minimum payments will produce a receivable with a long life, while a consumer making a payment greater than the minimum but less than the full balance will have a shorter expected life. Complicating matters further, consumers often change their payment behavior so a "transactor" may become a "revolver," and vice versa. Unlike closed-ended loans that have a fixed loan amount, payment amount and contractual maturity date, credit card "lives" continually increase or decrease each month as the net result of new purchases and payment rates.

In addition to the complexity of calculating the expected life of a credit card loan, equally challenging is calculating the lifetime expected loss rate. Loss rates for credit cards require an entity to determine how much of today's balance will still exist at the time the loan is expected to charge-off. New purchases expected to occur in the future are excluded from this estimate since they are not part of the recorded balance of the loan as of the measurement date, nor are they associated with a legally binding loan commitment. Roll rate methodologies are effective at estimating losses over the near term; however, when applied over a longer duration, their accuracy is less verifiable given the co-mingling of new balances with those that existed as of the measurement date.

While it can be said of any forecasting model that the accuracy diminishes as the time horizon expands, this is especially true for forecasts of credit card losses due to the volatile nature of the underlying assumptions as described above. Given the significant impact provision expense and the allowance balance has on the financial results of a financial institution, we believe the allowance estimation process should be based on reliable and verifiable methods and assumptions. We do not believe lifetime loss estimates for credit card portfolios can consistently achieve the high degree of accuracy necessary for financial reporting. Accordingly, we recommend the expected loss model require coverage over the period considered to be reliably predictable by the entity. Recognizing entities may differ in the time period considered reliably predictable, we further recommend requiring entities disclose by asset class the time period covered by their allowance estimation process.

### Incorporation of the Time Value of Money

The difficulties of calculating expected lifetime losses notwithstanding, there is an additional complication unique to credit cards in applying the time value of money to expected post-chargeoff recoveries; specifically, determining what, if any, interest rate should be used for discounting. Unlike collateralized loans, credit cards frequently experience a significant delay between the charge off and subsequent collection of recoveries. When employing a discounted cash flow approach, using the effective interest rate as the discount factor to calculate the present value of the future expected cash flows is a reasonable approach prior to point of charge off. However, using the effective interest rate on subsequent post-chargeoff recoveries does not seem appropriate; recoveries by their nature are "risk free" since the loss has already been taken. Discounting at a 0% rate, or alternatively a "risk free rate" such as the comparable maturity US Treasury instrument, is more logical but would perhaps exaggerate the relationship between the expected loss and the expected recovery. We believe the FASB should further consider how to incorporate the time value of money overall, particularly in light of this unique scenario.

# Non-Accrual Principle

While The Proposal's suggested treatment for non-accrual of loans is reasonable, regulatory guidance does not require non-accrual treatment for consumer loans and there is a long accepted practice between the credit card issuers and the banking regulators of not placing credit card accounts on non-accrual. Instead of placing credit cards on non-accrual, the regulators expect all banks to employ other appropriate methods to ensure that income is not overstated. This is typically achieved by reserving for uncollectible interest and fees with offsetting charges to interest and fee income either at the time of accrual ("income suppression") or at chargeoff ("chargeoff purification") This long accepted industry convention differs from the non-accrual proposal in that any payments received prior to charging off will continue to be applied using the standard payment allocation methods; typically reducing non-principal balances first. Implementing the non-accrual and cost-recovery methods within credit card servicing platforms would require a significant amount of time and resources for minimal effect. The existing practice is well understood by both regulators and institutional investors and changing to a non-accrual convention would not

increase understanding or transparency. Moreover, since issuers already disclose delinquency levels it would seem the change to a non-accrual convention would not provide incremental useful information. Finally, it would be a mistake to underestimate the operational complexity involved in requiring card issuers to adopt the prescribed non-accrual treatment and the related cost recovery treatment. We view the non-accrual proposal as an expensive change that does not provide analytical or disclosure benefits.

# Troubled Debt Restructurings (TDRs)

The proposed TDR guidance requiring modification of the loan's cost basis so that the effective interest rate on the modified asset continues to be the original effective rate given the new series of contractual cash flows seems unnecessary and may have some unexpected outcomes. Since credit cards do not have contractual due dates or fixed payment amounts, determining the adjustment amount will require reliance on significant assumptions. Assuming the borrower performs in accordance with the modified terms and repayment assumptions, applying the proposed TDR guidance to such loans' principal balance adjustment results in presentation of principal charge offs that have not occurred and higher interest income than the modified contract stipulates. We do not believe this presentation is preferable to the current practice whereby the difference between the loan's carrying amount and the present value of the modified cash flows discounted at the original effective interest rate (i.e., foregone interest) is recorded as an allowance for loan losses. The existing TDR disclosures provide financial statement users with sufficient information regarding the level of TDR activity and the related financial effects. Therefore, we recommend the revised TDR guidance be eliminated. Given the FASB's stated desire to keep principal and interest separate, the proposed treatment seems contradictory: a re-performing TDR will effectively convert original principal into interest yield based on the adjusted loan balance. An additional and more simplistic approach would be to eliminate the current TDR guidance and require disclosure of all modifications. Moreover, if the proposed TDR guidance is retained in the final accounting standards update, we request additional transition guidance be provided specific to TDRs. For example, upon transition, should the cost basis of all existing TDRs be adjusted using the remaining contractual cash flows at the time of transition or should we retrospectively calculate what the adjustment would have been at the time of modification?

# **Purchased Credit Impaired Model**

We feel that the proposal for PCI loans is superior to current GAAP. Reflecting the expected credit loss as a Day 1 allowance is both intuitive and helpful and would serve to make period to period ALLL comparisons more understandable. Under the current rules, an institution acquiring a large portfolio at fair market value, which includes an expectation of loss, would appear to have a smaller ALLL post acquisition (all other things being equal). This is distorting the risk position of the portfolio. The proposed PCI treatment is a more transparent way to reflect the true economics of an arms-length sale transaction. Moreover, we believe this methodology should apply to all loan purchases, not just those that have experienced significant deterioration in credit quality since origination. In any open market asset purchase, there is an implicit assumption of credit risk embedded within the purchase price even for an asset purchased at a premium. The purchase price of credit card portfolios, which have historically traded at some of the largest premium values for any loan product, are always calculated in a way which reflects expected losses.

## Transition Guidance

Given the complexity of The Proposal, if the FASB finalizes the guidance as proposed, we believe additional transition guidance is necessary. As stated in the TDR discussion above, we urge the FASB to consider eliminating the proposed TDR guidance, but if not, then additional transition guidance for TDRs existing as of the date of adoption is needed. Additionally, if the final guidance requires the allowance to capture lifetime expected credit losses, we believe additional guidance on life of loan calculations for credit cards and applying the time value of money concept to post charge-off recoveries would be very beneficial. And while we understand FASB's objective to find industry-wide practice applications, we do feel certain aspects of The Proposal, for example the non-accrual treatment, offer no real benefits to credit card industry observers or investors and, consequently, should be "scoped out" of the final guidance.

We appreciate your consideration of our comments on The Proposal and we look forward to continual dialogue with the FASB.

Cordially,

John A. Costa

Managing Director Auriemma Consulting Group

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