



#### D. Keith Bell

Senior Vice President Accounting Policy

The Travelers Companies, Inc. One Tower Square, 6PB A Hartford, CT 06183

Phone: 860-277-0537

Email: d.keith.bell@travelers.com

Technical Director – File Reference No. 2012-260 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Via E-mail:

Attn: director@fasb.org
File Reference No. 2012-260

Re: Proposed Accounting Standards Update on Financial Instruments-Credit Losses

#### Dear Sir or Madam:

The Travelers Companies, Inc. (Travelers) appreciates the opportunity to comment on the Financial Accounting Standards Board's (the FASB or the Board) Exposure Draft (ED), *Proposed Accounting Standards Update on Financial Instruments-Credit Losses* (Subtopic 825-15). Travelers is a leading provider of property and casualty (P&C) insurance products and services to a wide variety of businesses and organizations as well as to individuals. As a P&C insurer with a \$73 billion investment portfolio which supports our liabilities, Travelers is very interested in the proposed changes to the accounting for credit losses. With a portfolio that consists primarily of debt securities, our comments are from the perspective of a preparer and focus on debt securities and not loans, other than to raise a concern with the flexibility provided in the proposed guidance that may lead to comparability issues.

Travelers appreciates the pressures put upon both the FASB and the International Accounting Standards Board to address the perceived deficiencies with the current impairment guidance; however, it appears that the deficiencies that were identified with the impairment guidance for loans do not hold for debt securities. During the credit crisis, the impairment guidance for debt securities was revised as it was resulting in substantial impairments due to market disruption and not credit losses. This ED addresses the exact opposite problem. Additionally, the objective of the current guidance is to recognize credit losses on an expected loss basis using the present value of cash flows expected to

be collected, which appears to be in line with the objective in the ED. However, current impairment guidance better aligns with how securities are managed, is more practical, has less implementation issues, and provides financial statement users with information that is readily understandable

If the Board decides to include debt securities in the scope of this guidance, we have several suggested improvements that would improve the practicality of the guidance. These proposed changes include amending the language to be more neutral as to whether entities should perform the analysis on an individual or portfolio basis, eliminating the probability weighting criteria and instead emphasizing that the objective is a mean estimate, eliminating the allowance for securities analyzed on an individual basis and amending the practical expedient as discussed below. These changes would allow entities to continue with their current processes for identifying debt securities that warrant further impairment analysis.

In addition to the above concerns and suggested improvements, we have significant concerns with the inclusion of reinsurance receivables in scope of the guidance.

# **Practical Concerns for Debt Securities**

#### Portfolio Analysis

As currently drafted, the guidance for analyzing individual securities is not operational and would result in entities having to create an allowance account on a portfolio basis. In order to analyze credit losses on an individual basis, entities would need to evaluate each security held (e.g., over 7,000 CUSIPS for Travelers) when interest rates return to historical levels using probability-weighted scenarios. We believe that analyzing a large number of debt securities while documenting the analysis and certifying the process (including support for the scenarios) in the time needed to meet the quarterly and annual filing deadlines of the Securities and Exchange Commission (SEC) will force entities into portfolio evaluations. This brings an added problem of attempting to define homogeneous portfolios and applying appropriate default statistics. We believe that it is likely that rating agency default statistics will become the standard assumption since it will be very difficult to prove that an entity's past portfolio performance is more appropriate for estimating expected losses than the market averages. In addition, since it is extremely difficult to predict economic cycles, it is likely that the rating agency default averages will be used without adjustment.

The end result is that the allowance account will not change significantly over time other than for increases or decreases in portfolio size and, under severe stresses, when companies add to the allowance account for individual securities. When write-offs of uncollectible amounts occur, the allowance account will be used and immediately brought back to historical averages. We believe that all these factors would result in a model that is inferior to the current impairment guidance for debt securities.

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We suggest that if the Board amends the current guidance for debt securities, that guidance be added to better allow for an individual impairment analysis of debt securities.

# Probability-Weighting

There appears to be a misunderstanding as to what a "best estimate" is intended to convey and what current practice is in estimating future economic scenarios. We believe that most preparers are attempting to determine the expected credit losses under current impairment guidance. We also believe that requiring probability-weighting (albeit only using two scenarios as described in the ED) is as subjective as the current best estimate methodology and does not improve reporting without adding substantial cost.

Attempting to support and document estimated probabilities to potential outcomes will be extremely challenging since it is very subjective. We also believe that using the two required scenarios (i.e., one with a loss and one without) can lead to a higher allowance account than necessary for high credit quality securities and a lower allowance account than what is appropriate for securities that have experienced deterioration. Also, assuming a loss on all U.S. Treasuries, no matter how small, does not appear to be cost beneficial. Conversely, assuming no loss on a mortgage-backed security that has already exhibited deterioration of credit also does not appear appropriate as it is more likely than not that there will be further deterioration.

We suggest that the Board remove the probability-weighting requirement and instead stress the objective of the guidance, i.e., the expected credit losses.

## Allowance Account for Debt Securities Analyzed Individually

We do not believe the use of an allowance account for debt securities would provide more meaningful information than what is reported under current guidance. A portfolio analysis of individual debt securities from different issuers would be burdensome and may not be a credible approach as it is based on the premise that different issuers have similar credit and cash flow characteristics. The allowance concept appears to work better for groups of homogenous assets (e.g., similar types of loans) where it is difficult to identify individual impairments in a timely fashion due to a lag in obtaining information. We also struggle to understand the information value of the proposed contra-asset reporting for debt securities that are reported at fair value with changes in fair value reported in other comprehensive income (FV-OCI).

We recommend the Board eliminate the allowance concept for debt securities or, at a minimum, for debt securities that are analyzed for impairment on an individual basis. We also believe that the Board may want to consider a change to current guidance to allow reversals of impairments if new information indicates that previous impairment charges were too large. Such an approach would be analogous to the use of an allowance.

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# Practical Expedient

As currently drafted, the practical expedient in the ED would allow an entity to not recognize expected credit losses for financial assets measured at FV-OCI when both: (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset, and (b) the expected credit losses on the individual financial asset are insignificant. We are concerned that this expedient is too limited and does not address practicality concerns. Currently, preparers utilize various criteria or screens and develop watch lists using that criteria to identify securities that warrant further impairment analysis. It is not possible in a timely manner, nor warranted, to dramatically expand the population of securities that would require individual analysis as a result of a small shift in interest rates, as the outcome to each security is unlikely to be different. As noted above, the "too little, too late" phenomenon was not an issue with debt securities during the crisis, as the issue was the recognition of impairments based on fair value when fair value was not indicative of future cash flows. In hindsight, it appears that the current debt security impairment guidance has performed fairly well in the last few years and does not appear to be in need of major revisions.

If the Board moves forward with including debt securities in the final guidance, we recommend that, at a minimum, the practical expedient be amended from requiring both conditions described above to only one or the other. This would allow for a more practical solution and would be in line with current processes and with how companies manage their debt securities.

## **Reinsurance Receivables**

We were surprised that reinsurance receivables were included in the scope of the ED for a couple of reasons. First, conceptually we find it confusing to have a receivable subject to two different accounting standards for impairment. Second, we already analyze our reinsurance recoverables on an expected basis and do not bifurcate dispute risk from credit risk as it is difficult if not impossible to know the reasons or motivations of reinsurers. Instead, it is more important to determine if and how much is expected to be received from the reinsurer. We do not believe that attempting to bifurcate the risks would lead to better information as the bifurcation would be arbitrary and based upon conjecture rather than reliable information.

## **Summary**

Although we generally support the objective of the ED as it aligns with the current impairment guidance for debt securities, we do not believe that the ED is an improvement over current guidance on a cost-benefit basis. Additionally, we are concerned about the practicality of applying the guidance to debt securities as it would be extremely challenging to comply with the required analysis in the time necessary to be able to meet the SEC reporting deadlines.

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We thank you for the opportunity to comment on the ED and would be pleased to discuss our views with the Board in any forum the Board may hold. If you have any questions or would like to discuss our comments, please feel free to call me at (860) 277-0537.

Regards,

D. Keith Bell

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# **Questions for Respondents**

**Question 1:** Do you agree with the scope of financial assets that are included in this proposed Update? If not, which other financial assets do you believe should be included or excluded? Why?

We disagree with the scope. We believe that the Board should focus on improving the accounting for credit losses for loans, especially since loans and debt securities have different characteristics and the accounting for the impairment of debt securities was already appropriately addressed during the credit crisis. We also strongly disagree with including reinsurance receivables in scope due to the inability to reliably distinguish between dispute risk and credit risk. Additionally, it would be difficult to apply two different accounting standards to the accounting of reinsurance receivables.

**Question 9:** The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectibility of the financial assets' remaining contractual cash flows. Do you foresee any significant operability or auditing concerns or constraints in basing the estimate of expected credit losses on such information?

Yes, applying the model to debt securities will be very challenging as the guidance appears to favor a portfolio approach rather than an individual analysis approach. We believe that since there is significantly more information available for debt securities and they are managed on an individual basis, that an individual analysis is more appropriate. Favoring a portfolio approach causes significant concerns for debt securities. We believe that it would be difficult to separate the portfolio into homogenous groups and apply the rating agencies' average default statistics to the various groups as the historical default statistics may not be sufficiently granular. We also do not believe that this is appropriate as our default history has been superior to the average historical default rates but attempting to substantiate that this experience would continue in the future could prove extremely challenging. Also, using the rating agencies' averages will mean that the allowance account will not change significantly and would only change when the portfolio changes or when the economic situation worsens dramatically, bringing into question if this is an improvement over the current situation.

Question 10: The Board expects that many entities initially will base their estimates on historical loss data for particular types of assets and then will update that historical data to reflect current conditions and reasonable and supportable forecasts of the future. Do entities currently have access to historical loss data and to data to update that historical information to reflect current conditions and reasonable and supportable forecasts of the future? If so, how would this data be utilized in implementing the proposed amendments? If not, is another form of data currently available that may allow the entity to achieve the objective of the proposed amendments until it has access to historical loss data or to specific data that reflects current conditions and reasonable and supportable forecasts?

While this might be true for entities with loans, it is not a reasonable assumption for entities with debt securities. Travelers does not keep track of this information since we perform an impairment analysis on an individual securities basis that aligns with our credit decisions.

As discussed above, we believe that insurers making investment decisions on an individual security basis would be forced to use the rating agencies' average default statistics which may not be predictive of expected credit losses on individual securities, but would be significantly easier to support than attempting to document that past experience with the portfolio is an adequate predictor of future experience.

Question 11: The proposed amendments would require that an estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results. This proposal would prohibit an entity from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode). As described in the Implementation Guidance and Illustrations Section of Subtopic 825-15, the Board believes that many commonly used methods already implicitly satisfy this requirement. Do you foresee any significant operability or auditing concerns or constraints in having the estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results?

Operationally, assigning probabilities is not superior to estimating one scenario since the selection of probabilities is highly subjective and may lead to the same outcome. We believe that the Board should emphasize the principal and not dictate how to accomplish the principal. We also believe that using at minimum the two stipulated outcomes will lead to allowance accounts that are too high for high quality asset classes and lower allowance accounts than the current impairment model for other asset classes. Assuming a loss on all treasuries, no matter how small, does not appear cost beneficial. Conversely, assuming no loss on a mortgage-backed security that has already exhibited deteriorated credit does not appear appropriate either as it is more likely than not that there will be further deterioration.

Question 12: The proposed amendments would require that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. Methods implicitly reflect the time value of money by developing loss statistics on the basis of the ratio of the amortized cost amount written off because of credit loss and the amortized cost basis of the asset and by applying the loss statistic to the amortized cost balance as of the reporting date to estimate the portion of the recorded amortized cost basis that is not expected to be recovered because of credit loss. Such methods may include loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors. Do you foresee any significant operability or auditing concerns or constraints with the proposal that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly? If time value of money should not be contemplated, how would such an approach reconcile with the objective of the amortized cost framework?

#### No comment.

Question 13: For purchased credit-impaired financial assets, the proposed amendments would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be recognized as interest income. Apart from this proposal, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for expected credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired assets and non-purchased-credit-impaired assets as baddebt expense rather than yield. Do you foresee any significant operability or auditing concerns or constraints in determining the discount embedded in the purchase price that is attributable to credit at the date of acquisition?

# No comment.

Question 14: As a practical expedient, the proposed amendments would allow an entity to not recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. Do you foresee any significant operability or auditing concerns or constraints in determining whether an entity has met the criteria to apply the practical expedient or in applying it?

The practical expedient is not sufficient since in a rising interest rate environment almost all debt securities held would need an analysis. Although we prefer the current guidance, if the Board decides to keep debt securities in the scope of the proposed guidance, we

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recommend that the practical expedient be changed from requiring that both conditions are met to only needing to meet one or the other of the conditions. This would allow for a more practical solution and be in line with current processes and with how companies manage their debt securities.

**Question 15:** The proposed amendments would require that an entity place a financial asset on nonaccrual status when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. In such circumstances, the entity would be required to apply either the cost-recovery method or the cash-basis method, as described in paragraph 825-15-25-10. Do you believe that this proposal will change current practice? Do you foresee any significant operability or auditing concerns with this proposed amendment?

No comment.

Question 16: Under existing U.S. GAAP, the accounting by a creditor for a modification to an existing debt instrument depends on whether the modification qualifies as a troubled debt restructuring. As described in paragraphs BC45–BC47 of the basis for conclusions, the Board continues to believe that the economic concession granted by a creditor in a troubled debt restructuring reflects the creditor's effort to maximize its recovery of the original contractual cash flows in a debt instrument. As a result, unlike certain other modifications that do not qualify as troubled debt restructurings, the Board views the modified debt instrument that follows a troubled debt restructuring as a continuation of the original debt instrument. Do you believe that the distinction between troubled debt restructurings and nontroubled debt restructurings continues to be relevant? Why or why not?

No comment.

**Question 18:** Do you foresee any significant operability or auditing concerns or constraints in complying with the disclosure proposals in the proposed Update?

We are concerned with the operability of the overall model and supporting some of the information required in the disclosure proposals.

**Question 19:** Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient? If not, what additional guidance or examples are needed?

No, there should be additional guidance to address how the provisions would apply to debt securities. It would also be helpful to better understand how entities would attempt to determine the "credit risk adjustment", as it appears difficult to support from a computational and documentation perspective.

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**Question 20:** Do you agree with the transition provision in this proposed Update? If not, why?

Yes

Question 21: Do you agree that early adoption should not be permitted? If not, why?

Yes.

**Question 22:** Do you believe that the effective date should be the same for a public entity as it is for a nonpublic entity? If not, why?

No comment.

**Question 23:** Do you believe that the transition provision in this proposed Update is operable? If not, why?

Yes.

**Question 24:** How much time would be needed to implement the proposed guidance? What type of system and process changes would be necessary to implement the proposed guidance?

We have not completed a full analysis, but believe that attempting to put in place new Sarbanes-Oxley compliant processes for determining expected credit losses on a portfolio would likely cause timing issues at the end of each reporting period as preparers would need to apply it to individual debt securities rather than to a portfolio.