

COMMITTEE ON CAPITAL MARKETS REGULATION

May 31, 2013

Technical Director
Financial Accounting Standards Board (the “**Board**”)
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

VIA E-MAIL SUBMISSION: director@fasb.org

Re: Proposed Accounting Standards Update, Subtopic 825-15: *Financial Instruments—Credit Losses*; Exposure Draft; File Reference No. 2012-260 (the “**Exposure Draft**”)

Dear Members of the Board:

Founded in 2006, the Committee on Capital Markets Regulation (the “**Committee**”) is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-three leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

We are grateful for this opportunity to comment on the Exposure Draft. The Committee recognizes the limitations of the “incurred loss” credit impairment model currently applicable under generally accepted accounting principles in the United States (“**U.S. GAAP**”) and International Financial Reporting Standards (“**IFRS**”), and we are generally supportive of a more forward-looking loan loss reserve recognition process. However, we are concerned that the Exposure Draft, if implemented, may result in significant unintended consequences and would urge the Board to reconsider certain of its provisions.

First, the proposal requires subject financial institutions to base their reserve recognition procedures on unreliable and potentially volatile estimates of remote future events, imposing considerable implementation costs for little tangible benefit. Second, the significant differences between the Exposure Draft and the pending proposal of the International Accounting Standards Board (“**IASB**”)¹ threaten to harm the competitive standing of the U.S. financial sector *vis-à-vis* foreign competitors. Finally, the proposed “life of asset” expected loss approach is uniquely unsuited to the debt securities market, and the Board should exclude such instruments from the scope of the Exposure Draft.

¹ Int’l Accounting Standards Bd., *Financial Instruments: Expected Credit Losses* (Mar. 2013), available at <http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognition/Impairment/Exposure-Draft-March-2013/Comment-letters/Documents/ED-Financial-Instruments-Expected-Credit-Losses-March-2013.pdf>.

Comparison of Incurred Loss Model, Exposure Draft, and IASB Proposal

Under current U.S. GAAP and IFRS, a lending institution must make an allowance for “incurred” loan and lease losses when (a) “information available before the financial statements are issued or are available to be issued . . . indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements” and (b) “the amount of loss can be reasonably estimated.”² In determining the size of this allowance, a financial institution generally considers historical experience and present conditions—including exogenous factors, such as macroeconomic conditions—in modeling its loss estimates.³

Loan loss reserves reduce the value of a financial institution’s loan assets and, as a result, reduce the institution’s capital reserves by an equivalent amount. The size and timing of loan loss reserves are thus critical to the regulation of capital. Under the incurred loss model, loan loss reserves are typically understated during strong economic times. By contrast, during financial crises or economic downturns—*i.e.*, when the probability of impairment events generally increases—institutions must substantially increase their loan loss reserves, thereby reducing their capital buffers. For example, following the 2008 financial crisis, U.S. banks increased their loan loss reserves from approximately \$50 billion to over \$250 billion.⁴ The attendant reduction in capital can cause a decrease in lending activity, potentially exacerbating systemic risk and prolonging economic downturn.

The Exposure Draft eliminates the incurred loss model’s “probable” threshold, instead requiring reporting entities to recognize an allowance for expected credit losses on all loans as of each reporting date.⁵ “Expected credit loss” is defined as “a current estimate of all contractual cash flows not expected to be collected.”⁶ The Exposure Draft also expands the scope of information on which reporting entities must rely in estimating credit losses. In addition to “information about past events, including historical loss experience with similar assets” and “current conditions,” the Exposure Draft calls for entities to incorporate “reasonable and supportable forecasts and their implications for expected credit losses.”⁷

Like the Board’s approach, the “three buckets” or “three stages” approach proposed by IASB would incorporate historical experience, current conditions, and reasonable and supportable forecasts in estimating expected credit losses. However, in practice, the Board and IASB approaches will differ significantly as to the timing of loss recognition. Under the IASB proposal, recognition as of a given reporting date is based on expected shortfalls in contractual cash flows and is limited to defaults expected over the next 12 months, unless the relevant financial assets

² ACCOUNTING STANDARDS CODIFICATION, § 450-20-25 (Fin. Accounting Standards Bd. 2009).

³ Fin. Accounting Standards Bd., *Financial Instruments—Credit Losses (Subtopic 825-15)*, at 3 (Dec. 2012), available at <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175825477164&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs>.

⁴ Michael Rapoport, *Rule Split to Put U.S. Banks at a Loss*, WALL ST. J., Feb. 28, 2013, at C1.

⁵ Fin. Accounting Standards Bd., *supra* note 3, at 14.

⁶ *Id.*

⁷ *Id.* at 15.

have undergone “significant credit deterioration.”⁸ In the event of such deterioration, the full amount of expected loss would be recognized immediately. The IASB proposal will also likely lead to lower reserve levels than many U.S. financial institutions recognize for commercial and other loans, where greater than 12 months of reserves are often recognized, depending upon the asset class.

Critique of the Exposure Draft and Recommendations

Reliability and Volatility

The Exposure Draft would require financial institutions to project numerous economic factors (e.g., default rates and housing prices) into the remote future. However, the reliability of economic and credit forecasts beyond a 12- to 24-month horizon is generally *de minimis*. Amassing sufficient data to substantiate such forecasts as “reasonable and supportable” is likely to prove challenging, if not impossible, and, in any event, investors and other end-users of financial statements are unlikely to heed projections predicated on distant future events. Thus, the Exposure Draft would likely have the unintended consequence of reducing the accuracy of an institution’s loan loss reserves. By contrast, the IASB “three bucket” proposal requires forecasts over a more reasonable term of 12 months from the reporting date, absent any indication of significant credit deterioration.

The Exposure Draft’s forecasting requirements will capture contingent losses. To the extent that the goal of recording such contingent losses is to strengthen capital adequacy, we believe that this objective would be better addressed by regulatory means rather than by changing the underlying accounting treatment. Just as catastrophic loss reserves are not recorded for likely but contingent future catastrophic events,⁹ credit impairment losses should not be recorded for likely but contingent changes in credit cycles.

The Exposure Draft may also introduce significant volatility to the reserving process. When extended across the expected lifetime of certain assets—for example, the 7- to 10-year expected lifetime of a 30-year home mortgage—even slight changes in economic indicators serving as the basis for loss forecasts could result in significant reserve volatility from period to period. In the early stages of an unexpected economic downturn, the results could be especially dramatic, as rapidly deteriorating economic indicators are extrapolated across the full lifetime of a home loan lender’s balance sheet loan assets. While the incurred loss model may have required “too little, too late” in 2008, the Exposure Draft could contribute significantly to the procyclicality of the banking system, thus accelerating an incipient recession.

To address these concerns, we would first encourage the Board to clarify its interpretation of the term “expected,” as this will have a significant effect on the types of data used by financial institutions to support their estimates. Consistent with other industry commenters, we support an interpretation of “expected” that includes only those future losses that institutions believe can be estimated with “reasonable confidence,” without regard to whether a loss was already incurred. Indeed, further interpretive guidance as to the meaning of “expected credit losses” is logically necessary, given that the Exposure Draft’s definition is circular (*i.e.*, such losses are defined as “a

⁸ Int’l Accounting Standards Bd., *supra* note 1, at 39.

⁹ ACCOUNTING STANDARDS CODIFICATION, § 944-40-55-2 (Fin. Accounting Standards Bd. 2009).

current estimate of all contractual cash flows not *expected* to be collected” (emphasis added)). Our suggested approach would simplify the analysis and require fewer changes to financial institutions’ credit evaluation processes, while at the same time achieving the forward-looking risk management that the Exposure Draft sets as its objective. Furthermore, limiting “expected” losses in this manner would likely reduce volatility in loan loss and capital reserves by simplifying the factors involved in the relevant calculations.

An alternative approach would be to amend the Exposure Draft to set the expected loss measurement period to the greater of 12 months or a period that is “reliably estimable and predictable,” thus setting the presumptive duration of forecasts at a more reasonable 1-year period rather than the Exposure Draft’s life of asset duration.¹⁰ Such an amendment would still capture virtually all expected credit losses for non-performing assets, as negative credit risk indicators tend to appear early in the life of a given asset. Moreover, estimates of expected credit losses would by definition be premised on a more reliable basis than the Exposure Draft’s “life of asset” approach. While some might argue that the “reliably estimable and predictable” time horizon could evolve over time or even shrink during times of economic stress, in practice, reserve volatility would generally be curtailed by prudential management practices and regulatory scrutiny. Perhaps most importantly, this amendment could also facilitate convergence of the Board and IASB standards, thus mitigating the competitiveness concerns raised by the Exposure Draft.

Competitiveness

If both the Exposure Draft and the IASB proposal are implemented in their present form, U.S. financial institutions—most notably U.S. banks—will stand at a competitive disadvantage to their international peers. Assuming that no significant credit deterioration has occurred as to a given asset, a financial institution subject to the IASB proposal will be required to recognize reserves against losses expected over the immediately following 12-month period. By contrast, a U.S. competitor will be required to recognize reserves against losses expected over the full lifetime of an economically equivalent asset. As noted earlier, this is tantamount to an additional capital charge against U.S. financial institutions. For example, some have estimated that U.S. banks will have to increase loan loss reserves by close to 50% as a result of the Exposure Draft.¹¹ As U.S. banks currently hold \$162 billion in loan loss reserves,¹² this would represent a substantial write-down of U.S. bank capital. For certain classes of assets, such costs may be prohibitive in a competitive marketplace, and U.S. banks could see their business vanish or migrate overseas.

Inconsistent international standards will also complicate financial statement end-users’ ability to compare U.S. and foreign financial institutions and could affect the way investors view the strength of U.S. capital reserves. We urge the Board to consider comments received on the Exposure Draft in conjunction with the parallel comment process currently underway with respect

¹⁰ See Letter from U.S. Banking Industry to Leslie F. Seidman, Chairman, Financial Accounting Standards Board, and Hans Hoogervorst, Chairman, International Accounting Standards Board (May 10, 2013), available at <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175826921545&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs>.

¹¹ Rapoport, *supra* n. 4, at C1.

¹² *Id.*

to the IASB proposal. We would encourage the Board to work closely with IASB to develop an internationally consistent standard and ensure a level playing field.

Application to Debt Securities

The Exposure Draft's primary objectives are to provide financial statement users with more decision-useful information about expected credit losses and to reduce complexity by establishing a consistent measurement approach for both loans and debt securities. The Board asserts that the incurred loss model's "probable" recognition threshold interfered with the timely recognition of credit losses and overstated assets during the 2008 financial crisis. However, debt securities, which have readily determinable fair values, accurately and timely reflected the market's view of fair value. As a result, debt securities were *not* in fact overstated during the crisis, because they were either carried or otherwise disclosed at fair value. Fair value reflects the market's estimate of credit losses, and existing U.S. GAAP for debt securities—as modified in 2009—appropriately separates and recognizes "other than temporary impairment" credit losses in net income, whether or not the securities are carried at fair value. Current U.S. GAAP measures the expected credit loss by comparing the expected cash flows discounted at the effective interest rate of the debt security to the amortized cost and writes down the amortized cost.

We believe that the Exposure Draft has introduced unwarranted complexity for debt securities. Such complexity exists in two respects: (i) preparers must develop estimated credit losses on instruments that they may hold or sell, identify purchased credit impaired assets, and determine how to apply nonaccrual income recognition and cost recovery accounting to structured securities, and (ii) end-users will observe a reported interest yield that is understated for purchased credit impaired assets and unnecessarily variable due to nonaccrual income and cost recovery recognition rules.

Furthermore, financial institutions normally assess the credit risk of debt securities on a security-by-security basis, whereas the expected loss approach suggested by the Exposure Draft is more appropriate for establishing impairment for pools of assets (*e.g.*, loans). While superficially similar, the loan and debt markets are sufficiently distinct to warrant a more nuanced accounting treatment that recognizes the distinctions between these two types of instruments.

We therefore urge the Board to exclude debt securities from the scope of the Exposure Draft and retain the current impairment model under U.S. GAAP. The accounting treatment of "other than temporary impairment" of debt securities was significantly overhauled in 2009, and common industry practices on securities impairment, fair value frameworks, and fair value disclosure have developed in recent years to address what concerns did arise from the 2008 financial crisis.¹³ Today's accounting for debt securities appropriately identifies "other than temporary" expected credit losses in net income and maintains an amortized cost and expected yield that reflects the economics at the time of purchase, adjusted for changes due to prepayments, instrument-specific credit losses, debt modifications, and other factors. We believe the amortized cost basis of debt securities should continue to represent the present value of future

¹³ Letter from Michael L. Gullette, Vice President, Accounting and Financial Management, American Bankers Association, to Leslie F. Seidman, Chairman, Financial Accounting Standards Board (May 14, 2013), *available at* <http://www.aba.com/Solutions/Acct/Documents/ImpairmentABAcommentlettertoFASB2013FINAL.pdf>.

benefits and that the accretion between the present value and the future value should be recorded as interest income.

Because debt securities are carried or otherwise disclosed at fair value, and given the nature of the underlying debt securities markets, the criticisms of the loan loss reserve accounting model do not apply to debt securities. The existing reporting and disclosure of fair value, coupled with recognition of incurred credit losses, is a reliable framework to provide decision-useful information to users of financial statements. A change to an expected credit loss model for debt securities is not an improvement in financial reporting.

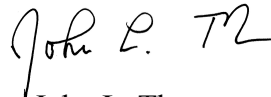
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Thank you very much for your consideration of our views. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Hal S. Scott (hscott@law.harvard.edu), or C. Wallace DeWitt, Executive Director of Research (cwdewitt@capmksreg.org) at your convenience.

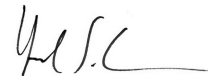
Respectfully submitted,



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