

# VIA ELECTRONIC TRANSMISSION director@fasb.org

May 30, 2013

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

Re: Proposed Accounting Standards Update:

Financial Instruments—Credit Losses, File Reference No. 2012-260

#### Dear Chairman Seidman:

The Illinois Credit Union League represents almost 300 federal and state-chartered credit unions in Illinois. We appreciate the opportunity to comment on the Financial Accounting Standards Board's (FASB) Proposed Accounting Standards Update on "Financial Instruments – Credit Losses (Subtopic 825-15)."

The proposed standard would very substantially change the methodology used for recognizing credit impairment.

<u>Current Process.</u> Credit unions currently recognize losses when such loss is considered "probable." They determine their Allowance for Loan and Lease Losses (ALL) accounts based on historical loss data, cash flow calculations and qualitative and environmental factors, reflecting expectations of losses and losses that have been incurred and will be charged-off during the next 12 months after the last reporting period.

<u>Proposal.</u> The proposal would impose a "current expected credit loss" approach, requiring covered entities to estimate the present value of cash flows associated with all loans and other assets that are not expected to be collected <u>over the life of the loan or asset</u> (i.e., at the time a loan is made they would be required to estimate losses that will occur over the life of the loan). The covered entity would be required to consider past events, current conditions, historical loss experiences, the borrower's credit worthiness, forecasts of expected credit losses and predictions about the economy over the life of

the loan. FASB states that credit loss reporting would not reflect a worst-case scenario or a best-case scenario and could not be based solely on the most likely outcome.

### **General Concerns**

## Financial reporting will be inconsistent with established accounting principles.

- 1. The proposal ignores a main principle of accounting, the matching principle.
  - When credit unions and other financial institutions make a loan, the interest rate charged is commensurate with the credit risk associated with the loan. Generally, the higher the credit risk, the higher the interest rate.
  - The proposal would require credit losses to be recognized immediately, while the interest income from the related loans will be recognized over the life of the portfolio.
  - If an institution determines it is not "probable" that it will receive "substantially" all of the principal or interest on the loan, the loan must be placed on nonaccrual status. This essentially changes the interest recognition to the cash basis of accounting, further skewing the matching of the provision for loan losses and the interest income. In addition, "substantially" is not defined and will be subject to varied interpretation by financial institutions and their regulators.
- 2. The proposal would require many lenders to recognize expected losses twice.
  - At loan origination, a lender considers the probability of default and this is factored into the interest rate and other terms of the loan so the loan is representative of market value based upon identified credit risk.
  - Also at loan origination, the proposal would require the lender to record an additional "current estimated credit loss" amount in the loan loss allowance.

Therefore, the lender would recognize the expected credit losses twice—through the initial pricing of the loan and through an addition to the loan loss allowance to recognize a current expected credit loss at the loan's inception.

# Life of loan economic forecasts are particularly uncertain and should not be used.

The proposal requires the estimate of credit losses to include reasonable and supportable forecasts that affect the expected collectability of the asset's remaining contractual cash flows. This in essence requires an institution to identify an economic model or forecast to rely upon to determine the possible cash flows on loans with terms that may span up to 30 years.

In choosing an economic model or forecast, the institution will find that there are there are a number of <u>very different</u> yet well respected economic models to choose from. This can also become somewhat contentious due to the different political beliefs and other subjective views of future economic trends of members of the institution's managing board.

The proposal requires an institution to estimate losses over the lifetime of the loan. This will in many cases substantially increase the allowance for <u>non-impaired loans</u> from current levels. As the life of the loan extends into longer future periods, this estimate is much more subjective and could also be manipulated to smooth earnings volatility.

In addition, the methodology will become much more subjective and will be much more difficult to substantiate and document for regulatory examination.

We believe a CFO of a large credit union succinctly summed up the overriding issue with life of loan forecasts, <u>"We need to leave forecasts by economists, or our attempts at being economists, out of this determination of credit losses. They have varying opinions about future events, but they cannot argue past events and current known events."</u>

## The FASB Proposal and IASB Proposal Differ Substantially.

While the FASB has indicated its intention to achieve a convergence of standards including credit losses with those of the International Accounting Standards Board (IASB), it is unclear how this will occur since the IASB's and the FASB's credit losses proposals are very different.

Unlike the FASB proposal, which does not include a trigger for recognizing certain losses, the IASB proposal provides that an entity would only recognize a portion of expected credit losses until a specific recognition trigger has been met. The IASB's credit losses model utilizes the following "two-bucket" approach:

- 12-month expected credit loss (Bucket 1): This category would require a full expected loss recognition only when there is a significant increase in credit risk since a loan was originated or acquired.
- Lifetime expected credit loss (Bucket 2): For all other assets, credit losses would be recorded based on the probability of a default occurring in the next twelve months.

There is concern among some within the accounting industry that the proposed FASB model has the potential of driving U.S. entities to report asset values more conservatively than their international counterparts applying the IASB's proposed credit loss standard.

### Credit Union Distinctions and Effect on Credit Unions

The proposal indicates the purpose of the change is to provide better information for investors or stakeholders. Credit Unions are cooperative in nature and have a completely different capital structure than Banks. Credit Unions are member-owned non-profit financial institutions designed to provide financial solutions for their members. Unlike banks which need to provide a substantial rate of return for their stockholders, credit unions are owned by their members and have no stockholders or other investors.

The proposed changes in how credit losses would be evaluated would require credit unions to provide information that is not relevant to the primary users of credit unions' financial statements--the federal and state credit union regulators, and credit union board members. Primary users will not be interested in credit loss estimates that are

based on subjective projections regarding future cash flows. (They may question why the credit union is making the loan in the first place if the credit union projects that payments will not be made.) They are interested in the credit union's reasonable analysis of the performance of its loans based on analytical components, such as under the current incurred loss model, and the extent to which the credit union has provisioned its ALL to reflect loan nonperformance.

### Effect on Net Worth

It has been estimated that the proposal could cause the loan loss allowance to double or triple. The increase would impose a very substantial additional expense on credit unions and in some cases will result in a substantial reduction in net worth.

With the exception of a few community development credit unions, the net worth of credit unions consists solely of their retained earnings so a depletion in net worth can only replenished through future net earnings.

While the regulators of other types of financial institutions are authorized to adjust their net worth requirements in response to changes in accounting standards, the Federal Credit Union Act does not authorize the National Credit Union Administration to make such adjustments for federal credit unions and federally insured state chartered credit unions.

The additional ALL funding expense resulting from the change in accounting standards could cause a lower net worth ratio which could trigger the NCUA's onerous prompt corrective action (PCA) requirements for numerous credit unions that are currently classified as "well-capitalized." The imposition of PCA would undoubtedly reduce the credit union's consumer lending.

Adopting the proposal will also result in other substantial expenses and concerns for credit unions.

- The proposal will require credit unions to expend extensive financial and technical resources to comply with the changes proposed, particularly to be able to forecast future credit losses. The costs of any such expenditures will be borne by credit unions' member-owners.
- Credit Unions vary dramatically in size and sophistication. Many credit unions will not have the resources to complete modeling for forward looking scenarios, as well as to continually re-evaluate collateral on a periodic basis. Unlike the models currently being used by credit unions—particularly smaller credit unions—that involve homogenous loan pools and application of historical loss ratios and environmental loan factors, the models considered in the proposal are much more complex and will therefore require significantly more resources to effect compliance.

The proposed model requires entities to predict the extent and timing of future impairments. Predicting such losses with any degree of accuracy will be extremely challenging, even for an entity with adequate data sets and modeling capability. Attempting to predict credit loss for the life of a loan will inherently be

affected by the subjectivity of and assumptions made by the reporting entity. Even the largest financial institutions have indicated that they do not have adequate information on this data and that it will take years (some estimating four to five years) to obtain. Since smaller financial institutions will require even more time to obtain such data, these institutions may have to rely on their larger counterparts for data, which will result in a delay in receipt of information. In addition, even after smaller institutions obtain adequate data, some practitioners are estimating it may take up to four more years for these institutions to become comfortable with the required modeling.

- Auditing costs are also likely to increase. It will be very challenging for auditors
  to become comfortable enough with these drastic changes to provide an opinion
  on the most significant estimate on a credit union's balance sheet. We anticipate
  an increase in audit fees as a result of the amount of work that will be required
  for auditors to become comfortable with these changes. In addition, the
  proposed changes will require credit unions to obtain costly core enhancements.
- As mentioned previously, the methodology will become much more subjective, and thereby more difficult to substantiate and document for regulatory examination. The changes may not be adopted by regulatory agencies which will increase burden on credit unions with limited resources.

The costs and complexity of the proposed changes could also ultimately result in the consolidation of credit unions that have difficulties complying with these changes. Such a result would not only affect the members of those credit unions directly involved, but would affect the larger financial services marketplace by reducing consumer financial options.

The proposed changes will not provide an amount of benefit commensurate with the additional expense.

The proposal indicates that the current "incurred loss" loss model improperly delayed the credit loss recognition in the aftermath of the global economic crisis. In fact no reputable economic forecast foresaw the extent of the downturn or that it would be global. (One can imagine the disdainful response in 2006 to anyone who suggested that General Motors would be forced to declare bankruptcy.) The effects of the great recession have continued much longer than anyone would have imagined. The life of loan forecast would not have accurately anticipated the loan losses incurred by some financial institutions.

There is no empirical evidence to support the concern that the current impairment methodology does not allow for the timely recognition of credit losses for credit unions generally. The current and continuing robust health of the credit union system, despite the financial crisis, supports the view that the vast majority of credit unions have been able to deal with credit impairment utilizing the present incurred loss approach. To the extent that accounting issues were involved in the small number of credit unions that experienced substantial loan losses and the smaller number that failed in connection with the financial crisis, NCUA's Inspector General's material loss reviews support a

conclusion that there was a misapplication of the current incurred loss methodology by the problem credit union, not the need for a new loan loss methodology.

Under the current loan loss method used by credit unions--

- Credit unions already are evaluating credit losses based upon the historical loss experience rate for assets, adjusted for changes in current conditions, changes in credit environment within their region, as well as scoring loans on a quarterly basis for possible changes in credit risk. Additional steps above and beyond the current procedure may not be cost beneficial and beyond the resources of smallto-moderate size credit unions.
- Credit Unions also evaluate loans for potential credit losses on an individual basis as well as a pooled basis. We believe this addresses the issue of looking at future collectability because individual loans are specifically reserved at a higher level if unfavorable conditions exist and are expected to continue in the foreseeable future.

# Potential Impact on Consumers, Small Businesses, Communities and the Economy.

We believe the proposal will have a chilling effect on lending in general. Depending on when the final standards are implemented, they could impede the financial recovery and restrict the ability of lenders such as credit unions to meet the credit needs of their communities. The proposal's requirement that losses over the life of a loan must be considered will likely result in creditors overestimating losses and over-reserving their ALL accounts, at least initially. To avoid the appearance of increasing losses creditors may adopt stricter loan standards (and may be encouraged to do so by examiners). Such a result could dampen lending and discourage creditors from providing loans to borrowers that are even marginally risky.

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## **Summary and Recommendations**

In light of the important and highly relevant distinctions between not-for-profit, cooperatively owned credit unions and publicly traded institutions, and in order to facilitate financial reporting that is the most accurate, credit unions' financial statements and financial reporting should reflect the uniqueness of credit unions and who the end users of their financial statements are, rather than requiring credit union reporting to meet standards designed to address problems presented by the for-profit bank model.

Credit unions should not be required to conform to accounting standards that are more appropriate for publicly-traded banks and other stockholder companies when such standards will impose significant costs and hardships on credit unions and their communities.

We urge the FASB to recognize the differences between credit unions and other financial institutions, particularly the largest banks who actively participated in activities

that contributed to the financial crisis. Credit unions should be allowed to continue reporting under the current methodology, which has not been shown to be problematic for the credit union system.

While we do not believe it would be appropriate to apply the proposed changes to credit unions, if the FASB moves forward with this proposal or a variation, it is crucial that the FASB work closely with the federal financial regulatory agencies throughout the remainder of the standard-setting process. We particularly urge collaboration to continue with NCUA in light of the unique structure of credit unions.

We also urge the FASB to consider a credit impairment approach that is more in line with the proposed IASB model, particularly the aspect of the IASB's model that uses a twelve-month forecast period. If the FASB moves in this direction, a new proposal should be issued for comments from stakeholders.

It is imperative that there is an adequate phase-in/transition period for credit unions for any new standards, which should be coordinated with the implementation of the new international standards. We urge the FASB to work with the IASB to delay the effective date of final, consistent credit loss standards for at least three years particularly for non-public reporting entities such as credit unions so they can benefit from the implementation process of larger, more sophisticated public entities.

Thank you for the opportunity to comment on this most important proposal.

Very truly yours,

ILLINOIS CREDIT UNION LEAGUE

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