PNC

September 28, 2010

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

File Reference: No. 1810-100, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

Dear FASB Board Members and Staff:

The PNC Financial Services Group, Inc. ("PNC"), one the nation's largest diversified financial services organizations, appreciates the opportunity to comment on the Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities* ("the ED"). The ED states the FASB's main objective is to "provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments, while reducing the complexity in accounting for those instruments."[1] We support the FASB in their efforts and share the FASB's goal in this regard. We appreciate the balance the FASB must strike as it considers differing perspectives in the accounting and reporting for financial instruments, including convergence with the IASB.

However, while PNC supports this objective, we do not believe the changes proposed in the ED will accomplish this goal. Our conclusion is based upon the following points:

- Investor Perspective – Our investors believe that current accounting and reporting practices are adequate and the ED would result in substantial change and complication without adding value.
- Business Strategy – Our primary business strategy is to benefit from/make payments based upon the cash flows of financial instruments versus trading them for profits and the accounting should reflect our business strategy.
- Mixed Measurement – The narrowing of three accounting methods (amortized cost, available-for-sale, and fair value) to two accounting methods (fair value through either other comprehensive income or net income) would no longer adequately recognize our business strategy/involvement in financial instruments. Additionally, we believe any changes to the equity method of accounting should not be made without further discussion and consideration.

---

[1] p. 1, Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities.*

- Credit Impairment – We support the use of a consistent impairment model, but one which permits consideration of future expectations and recognizes expected losses over the life of the loan.
- Complexity – The comingling of credit losses and interest income in measuring the performance of financial instruments increases rather than reduces complexity in the accounting and reporting for financial instruments. However, we are supportive of the FASB's attempt to reduce the complexity of hedge accounting.
- Operations – Adoption of the guidance as proposed will result in significant operational costs, including new processes and systems, which is only magnified when one considers repeating it upon a subsequent adoption of IFRS. Additionally, these proposed changes will impact the flow of capital through the economy.
- Convergence – The proposed accounting differs substantially from IFRS 9 and the IASB's current exposure drafts on financial instruments and widens the gap to converging to one set of worldwide accounting standards.
- Alternatives – Consistent with the alternative views expressed by Ms. Seidman and Mr. Smith[2], we believe the most meaningful change would result from changing the current accounting for credit impairment and retaining amortized cost accounting for financial instruments.

Our views, including proposed alternatives, are further elaborated below.

## Investor Perspective

Based upon discussions with our investors, they have indicated that current accounting for loans and liabilities at amortized cost appropriately reflects our business model and a shift to reporting these financial instruments at fair value would result in unnecessary and confusing volatility in our financial statements. This position is consistent with a survey performed by PricewaterhouseCoopers, *What Investment Professionals Say About Financial Instrument Reporting, June 2010.* Based upon the significant and fundamental changes proposed in the ED, and recent and potential future changes in the membership of the Board, we believe this proposed standard should be re-exposed before a final standard is issued.

## Accounting and Reporting Should Reflect Business Strategy

The ED would generally permit changes in the fair value of financial instruments for which an entity's business strategy is to hold for collection or payment of contractual cash flows to be reported in OCI. In this regard, "The Board believes that it is appropriate to distinguish between financial instruments that an entity is trading or otherwise holding for sale and financial instruments that are part of an entity's long-term asset-liability management or investment activities."[3] To this point, we note that the current alternative accounting treatments for 1) holding financial assets for long-term cash flows, 2) holding financial assets for long-term cash flows but making those assets available for sale in the event they are needed for liquidity and/or for other asset/liability management purposes, and

---

[2] Paragraph BC 244, Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities.*
[3] Paragraph BC98, Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities.*

3) holding financial assets for trading or short-term profit-taking more accurately reflects an entity's business strategy. As such, we strongly oppose changes to current accounting which are unnecessary and counter to the representational faithfulness principle. Additionally, the current ability to change the classification and accounting for financial instruments based upon changes in business strategy should continue to be permitted.[4]

**Mixed Measurement**

We originate and purchase loans in order to collect and receive a return based upon their contractual cash flows. Accordingly, we question why our business strategy of holding these financial instruments for investment should be accounted for at fair value with changes recorded either through net income or OCI. We believe the current accounting for the instrument at amortized cost is appropriate as it recognizes the expected economics of the business transaction. However, recognizing that extraordinary market conditions could change our intent and the expected economics of the loan transaction, if necessary, we believe additional fair value disclosures should be presented in the footnotes to the financial statements.

While we acknowledge that accounting for financial liabilities at fair value provides a degree of symmetry with accounting for financial assets at fair value, we question why financial liabilities should be reported at fair value and/or present value given our business strategy. We do not trade our financial liabilities, but instead settle them based upon their contractual terms – the terms that reflect the true cash flows of the obligations. The ED will generally require these financial instruments to be reported at fair value with changes in fair value reported in net income. We believe these financial liabilities should be accounted for at amortized cost and again, we agree with Ms. Seidman and Mr. Smith who state they "...dissent from several aspects of the proposed guidance, primarily because it would introduce fair value accounting for ... most liabilities held for payment, which they believe would not reflect the likely realization of those items in cash and, therefore, would not be the most relevant way to measure those items in the statement of financial position and comprehensive income."[5]

We oppose the valuation of core deposits as described in the ED as this introduces a measurement model that differs from fair value and will add an additional layer of accounting complexity. Similar to our financial liabilities, we do not trade core deposits but hold them for their duration such that fair value accounting is not warranted, and reporting them at their settlement amount is appropriate given our business strategy and model.

Furthermore, as currently written, it appears that changes in the fair value of available-for-sale ("AFS") securities would be reported in net income since prudent asset/liability management calls for these instruments to be sold for short-term liquidity purposes and/or asset/liability duration

---

[4] Paragraph 23, Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities*, states "The entity shall not subsequently change its decision made at initial recognition."
[5] p. 177, Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities*.

rebalancing from time to time and more than infrequently[6]. AFS securities are purchased and sold to cover duration and interest rate risk mismatches that may exist from customer related lending and deposit activities, as well as to provide a source of short-term liquidity and for pledging purposes related to governmental deposit accounts and other purposes, among other things. Since our primary business strategy is to hold these financial instruments for investment, interest rate risk, liquidity, capital management purposes and not for trading purposes, we believe financial instruments held for these purposes should continue to be carried at fair value with changes in fair value reported in OCI.

We believe that any changes to the equity method of accounting (which is effectively one line consolidation) should be evaluated for consistency with the current requirements for consolidation. In this regard, we note the inconsistency between the ED where equity method accounting is only permitted for an investee that has operations related to the investor and current consolidation requirements where an investor consolidates an investee with dissimilar operations. Additionally, we believe the views of the IASB need to be considered with the goal of convergence before any changes are made to the accounting for equity method investments.

**Credit Impairment**

PNC agrees with the removal of the probable threshold for recognition of credit losses as proposed in the ED, and believes this change will assist in reducing potential inconsistencies that exist today in determining when that threshold is met. We also believe credit losses for loans accounted for at amortized cost should be recognized based upon a consistent model, namely total expected losses over the expected life of a loan or pool of homogenous loans. However, we are strongly opposed to the recognition of credit losses in net income at origination of the loan. The contractual interest rate assigned to a loan anticipates a level of credit risk based upon our business strategy of collecting the principal and interest of the loan. Accordingly, the most relevant measure of impairment is to recognize provision for credit losses prospectively over the expected life of the loan in conjunction with the recognition of the compensating interest revenue. Although, in the event realized losses exceed the allowance for credit losses, this difference should be recognized through net income.

The proposed guidance also does not allow for changes in future expectations and instead requires assumptions based upon past history and existing conditions to be held constant.[7] This requirement would result in the overstatement or understatement of the allowance for credit losses at the peak and valley of credit cycles, respectively. Furthermore, prohibiting the use of, in particular, expectations of future events is inconsistent with the way the market views credit risk and market transactions. Several credit loss models have been proposed as alternatives to those described in the ED and proposed by the IASB. Although we do not endorse a specific model, we believe a credit model should allow changes in future expectations in the measurement of credit impairment.

---

[6] Paragraph BC 97, Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities*, states "such instruments should be held as part of a longer term business activity in which sales are **infrequent** [emphasis added], therefore, eliminating the current tainting notion."

[7] Paragraph 4, Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities*, states "an entity shall assume that the economic conditions existing at that point in time would remain unchanged for the remaining life of the financial assets."

## Comingling Credit Losses and Interest Income Results in Unnecessary Complexity

The ED proposes that interest income should be recognized by applying an asset's effective interest rate to the amortized cost balance of the asset net of any allowance for credit losses. Additionally, to the extent cash received exceeds interest income an entity would credit the allowance for credit losses for the difference.[8] Under this approach, interest income will never represent the effective yield on a loan due to the netting of the allowance against the balance. The Allowance for Credit Losses will be built through a combination of provision and reduced interest income. This approach is inconsistent with the way we manage our assets as we set and manage contractual interest rates based on market conditions and business strategy in a separate process from the analysis and development of the provision for credit losses.

Furthermore, the current recognition and reporting of interest income and credit losses is well understood and accepted by users of financial statements such that the commingling of interest revenue and credit losses in financial reporting is unnecessary. We are concerned that accruing interest income based upon the amortized cost balance of a loan, net of allowance, obscures and alters the reporting of contractual yields and credit losses and increases complexity for a user of our financial statements. Accordingly, we believe that interest income should continue to be recorded based upon the current practice of applying an effective rate to the amortized cost balance before credit allowance and credit losses should continue to be separately reported. In addition, we believe the current reporting model for interest income and credit losses more closely meets the overall objective of the ED.

Except for the prohibition against voluntary dedesignations of hedging relationships, we are supportive of proposed changes to hedge accounting. We support adjusting the effectiveness threshold from highly effective to reasonably effective, as well as eliminating the initial and continuing quantitative tests and replacing these test with a qualitative analysis. We believe these changes will simplify hedge accounting and reduce its operational burden.

## Operational Concerns

Overall, PNC believes the costs of implementing the ED significantly outweighs any possible benefits. The changes proposed are a significant departure from current accounting guidance in many areas and would affect virtually every component of a financial institution's financial statements. In order to apply the ED's changes to the accounting for credit losses and interest income extensive changes to systems and operational processes would be necessary. Applying the comingled credit loss and income recognition model to data stored separately would be impossible without building additional systems and requiring a major overhaul of current systems and processes to implement the new accounting and reporting requirements. We believe little of these changes are truly necessary as they do not reflect improvements for the industry.

---

[8] Paragraphs 76 and 80, Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities*, state "The amount of interest income … shall be determined by applying the financial asset's effective interest rate to the amortized cost balance net of any allowance for credit losses" and "The difference between the amount of the accrued interest receivable based on the amount of interest contractually due and the amount of interest income accrued shall be recognized as an increase in the allowance for credit losses."

Overall, business and lending practices will be impacted by these proposed changes. As further discussed above, the pro-cyclical nature of the proposed credit impairment model would likely result in less conservative lending practices instead of more appropriate conservative lending as one moves up the credit cycle and vice versa as one moves down the credit cycle. As a result of the focus on fair value, one would likely tend to make less longer term loans (requiring more frequent refinancing and increasing liquidity risk in the system) and use less core funding. The decreased value of core deposits would also reduce the franchise value for banks. Additionally, a financial institution would be much more tied to making loans based upon models rather than understanding the credit story of the borrower.

Under the proposed guidance in the ED, we believe additional clarity regarding the use of "open" and "closed" pools is necessary. It appears to us that loans would need to be aggregated into closed pools, which could result in a significant number of closed pools that toward the end of their lives hold very few loans, increasing the operational costs and reducing efficiencies. Further, we believe the proposed guidance will require a significant educational process for preparers, users and auditors of financial statements. When considering all of these factors, we question why an adjustment to the recognition threshold and use of an expected loss approach would not adequately address the reporting deficiencies that may be the impetus for this proposal.

## Convergence

Given the sweeping changes proposed in the ED, we believe the ED must be thoroughly vetted. While we acknowledge the FASB's work in this regard, we believe that more needs to be done, including re-exposing what we believe will likely be a vastly different final standard than the one proposed today. We encourage the Board to work with banking and financial regulators, to hold thorough and frank discussions to identify and mitigate discrepancies between the accounting and regulatory capital rules that exist today and that will be impacted by the accounting changes prescribed in the ED. As an example, the proposed guidance to stop recognizing interest when the yield of a loan is negative delays the reporting of and is dramatically different from the current practice with regard to determining the nonaccrual status of delinquent loans. We also strongly believe that any standard issued should, at minimum, have no significant conflicts with standards issued by or proposed by the IASB. To this point, the ED is significantly different than the classification and measurement guidance issued by the IASB which, if finalized, would result in significant costs and changes to adopt the ED and, with the high likelihood, that within a short period of time significant costs and changes would be required to adopt the IFRS standards.

**Closing**

We acknowledge the complexity of financial instrument issues and appreciate the Board's goal to improve the usefulness of financial statements. While we appreciate that there are merits to fair value, we do not believe that the significant changes to the use of fair value proposed in the ED are appropriate. We believe current accounting appropriately reflects an entity's business strategy and that impactful change can be made by adjusting the accounting for credit losses.

We appreciate the opportunity to share our views with the Board and staff and welcome any questions or comments you may have. Please contact me with any questions about these comments at 412.762.3900.

Sincerely,

Samuel R. Patterson
Senior Vice President and Controller
The PNC Financial Services Group, Inc.

cc Mr. Richard Johnson
Executive Vice President and Chief Financial Officer
The PNC Financial Services Group