



December 15, 2010

Ms. Leslie Seidman
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Sir David Tweedie
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Re: File Reference No. 1850-100, Proposed Accounting Standards Update,
Leases (Topic 840) and ED/2010/9, Exposure Draft, Leases

Dear Ms. Seidman and Sir David:

The Clearing House Association L.L.C. (“The Clearing House”),¹ an association of major commercial banks, appreciates the opportunity to comment on the above-referenced Proposed Accounting Standards Update (“Proposed ASU”) and Exposure Draft (“ED”) (collectively, the “Proposal”).

¹ Established in 1853, The Clearing House is the nation’s oldest banking association and payments company. It is owned by the world’s largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer and check-image payments made in the U.S. See The Clearing House’s web page at www.theclearinghouse.org.

Executive Summary

The Clearing House supports the efforts of the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”) (collectively, the “Boards”) to improve comparability, transparency and consistency in financial statements with respect to the accounting for leasing. In particular, we commend the Boards for developing an almost fully converged proposal, as we believe it is critical that the Boards continue to work together to produce a single set of high quality accounting standards. While we agree with the basic premise of eliminating the distinction between operating leases and financing leases from the perspective of the lessee, we have concerns regarding the precise methodology proposed, as well as the overall operational complexity of the model, and we therefore provide some suggestions regarding its improvement and simplification. With respect to the lessor accounting model, we do not believe the changes proposed constitute an improvement in financial reporting. Specifically, The Clearing House:

- *recommends* that the Boards not change the current accounting model for lessors, since the current accounting model for lessors is not in need of improvement and the proposed lessor accounting models are conceptually flawed;
- *agrees* with the basic model proposed for lessee accounting, but *disagrees* with the proposal to include optional lease periods and contingent lease payments in the measurement of the lease payment liability, as they do not meet the definition of a liability;
- *strongly recommends* that the Proposal distinguish between core and non-core leasing activities for both lessees and lessors, and permit non-core leases to be accounted for as operating leases (under existing lease accounting guidance), as non-core activities are by definition less relevant to users of financial statements;
- *strongly recommends* that interest expense relating to non-core leasing activities be excluded from net interest margin of commercial banks, to avoid distorting this key performance metric; and
- *recommends* that the Boards adopt a prospective transitional approach for existing leases, with a cumulative catch-up recorded in retained earnings, in order to ease the significant operational burden of the Proposal.

We provide further detail on each of these points below.

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A. The proposed accounting model for lessors does not constitute an improvement over the current model.

Overall, we do not support the proposed changes to the lessor accounting model. We do not believe that this is an area of accounting that is considered problematic by users or investors, and therefore we do not believe that the significant changes contained in the Proposal are warranted. Further, we believe that the two lessor accounting models proposed by the Boards have been insufficiently deliberated and are conceptually flawed, and therefore do not represent an improvement in financial reporting.

In particular, we believe that the proposed Performance Obligation method is inconsistent with the lessee right-of-use model. It is not clear to us why the lessor still has a performance obligation if the lessee has recorded an unconditional obligation to pay.

Furthermore, the Performance Obligation method results in the lessor recognizing two distinct assets on its balance sheet: a receivable for the expected amounts due under the lease contract, as well as the underlying asset. Assets are bundles of rights – in the case of property, plant, and equipment, these rights include the ownership of the asset and the right to lease it. We do not believe that the act of leasing an asset should result in the recognition of an additional asset. By recognizing an additional asset, the result of the Performance Obligation approach is that the assets recognized by the lessor will ultimately exceed the cash inflows expected from those assets.

The Derecognition method is flawed in that it produces a result wherein no one party records the underlying asset on its books. For example, in a lease of an airplane, the lessee recognizes a right-of-use asset and the lessor recognizes a residual asset; no one party recognizes the entire airplane.

Furthermore, the Derecognition method does not allow a residual asset to be discounted to its present value and accreted to its future market value. We believe that the residual asset should be accreted to its future market value, to give users the best information about its value.

Given the significant conceptual weaknesses of the lessor accounting models, we strongly recommend that the Boards leave the current lessor accounting model in place, as it is well understood by both preparers and users of financial statements and is not regarded as being in need of improvement.

However, if the Boards decide to change the lessor accounting model, we believe that there should be a single model whereby all leases, except non-core leases, are accounted for by the lessor as a financing lease. We believe that the direct financing lease model is well

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understood and does not pose the same conceptual issues as either of the two proposed methods. A single model would minimize the risk that economically similar arrangements would not be accounted for similarly.

More specifically, the direct financing lease model would most closely align lessor accounting with the way many small and large ticket equipment leasing businesses view and manage the underwriting, credit and residual risks related to their lease portfolios. Regardless of whether leases are currently accounted for as operating leases or as direct financing leases, most leases are viewed and managed primarily as a right to receive cash flows. For nearly all of these leases, the asset will either be sold at the end of the lease term or re-leased. As a result, including the residual value of the leased asset as an integral component of the lease financing receivable is a reasonable approach for all leases and likely would be easier for financial statement users to understand.

This approach also would simplify the implementation for many financial statement preparers, so that existing lease accounting systems could be utilized with fewer modifications required. Non-core leases (e.g., a sub-lease for a small portion of an owned or leased building by a non-real estate investment company) would continue to be accounted for as operating leases (in effect, as service arrangements) by a lessor.

1. The current leveraged lease accounting should remain unchanged.

For the same reasons, we believe that the Boards should retain the existing model for leveraged leases: the current model is well understood, is not in need of improvement, and the proposed approach has conceptual weaknesses. Under the Proposal, there will be double-counting in the accounting for leveraged leases: both the lessor and the leveraged debt lender will show a receivable for the right to receive payments. We believe that an asset should be reported on the balance sheet as an asset of only one entity, that is, the entity that enjoys the economic benefits and burdens of that asset. We note that several alternatives for leveraged lease accounting were evaluated prior to the issuance of Statement of Accounting Standards No. 13, "Accounting for Leases" and the current accounting was determined to best reflect the unique economics of these tri-party transactions.² Accordingly, we recommend that the Boards retain the existing model for leveraged leases.

B. We agree with the basic model for lessee accounting.

We agree with the basic premise of the proposed approach for lessee accounting, that is, to account for leases as on-balance sheet financings. However, we disagree with the

² See paragraphs 108-109 of that standard for the basis of conclusion supporting current leveraged lease accounting.

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proposed measurement methodology for the right-of-use asset and the lease obligation, as discussed further below.

1. Term extensions and contingent rents should not be included in the measurement model.

We do not support measuring the right-of-use asset by assuming the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease. Moreover, we also do not support the inclusion of contingent rentals, expected payments under term option penalties and residual value guarantees in the measurement of the right-of-use asset. In this regard, we agree with the dissent of Mr. Stephen Cooper,³ as follows:

- lease payments which an entity has no contractual or constructive obligation to pay do not meet the conceptual definition of a liability;
- including such amounts would therefore overstate financial leverage on the part of the lessee (and would also overstate the lessor's receivable, implying an exposure to credit risk when the reality is an exposure to underlying asset risk); and
- estimating contingent rentals and lease renewal periods out many years in the future would lead to a greater amount of subjectivity, and a consequent loss in reliability and comparability, in the financial statements.

Accordingly, we recommend that the Boards leave the current U.S. GAAP definitions of lease term and minimum lease payments in place for lessors and lessees, so that renewal options are included in the accounting lease term only if they are "reasonably assured" of being exercised by the lessee because of a contractual or non-contractual penalty for nonrenewal. We similarly recommend that the Boards leave the current U.S. GAAP accounting treatment for contingent rents unchanged. Information regarding lease renewal options and contingent rents could instead be provided more transparently via disclosure in the footnotes to the financial statements, along with minimum lease payment disclosures. This is more objectively measurable, promotes comparability and symmetry, and would result in liabilities that are existing liabilities of the lessee. Such an approach would accomplish the main objective of the Proposal of recording the lessee's obligation on the face of the balance sheet without the added complications discussed above.

The Proposal states that one reason for the proposed approach to optional lease periods and contingent rentals is to avoid "structuring opportunities".⁴ We agree with Mr.

³ Paragraphs AV1 through AV7 in the IASB exposure draft.

⁴ Paragraph BC123(b).

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Cooper that this concern should not outweigh the goal of providing relevant information to investors, and we further agree that it is possible to avoid “structuring opportunities” by (i) establishing principles for identifying optional lease periods and contingent rental arrangements that lack economic substance and represent disguised minimum rental payments and (ii) through enhanced disclosure.

If the Boards do not adopt this approach, we believe that, at a minimum, the measurement of the lease term should be based on only those lease renewals and terminations that are probable of occurring. The “more likely than not” threshold is simply too low to result in lease renewals and terminations being included in the calculation of a liability. Similarly, the calculation of contingent rents, expected payments under term option penalties, and residual value guarantees should be based on an estimation of what is probable of occurring. Again, the application of an expected outcome technique will result in the recognition of liabilities that are not probable of ever being incurred or paid.

2. The lessee asset and liability should be amortized on the same basis using the level-yield method.

We note that under the proposed approach, the right-of-use asset is amortized on a straight-line basis, whereas the lease payment liability is amortized using a level-yield method. We are concerned that over time the relationship between these balances could cause confusion for investors, and introduce greater volatility in leases recognized by lessees. Accordingly, we propose that the right-of-use asset be amortized on the same basis as the lease payment liability (i.e., on a level-yield method). Tying the amortization of the right-of-use asset to the periodic reduction of the lease liability would provide for greater operational simplicity as well as better transparency for users of financial statements, as the sum of the amortization of the asset and the interest expense on the liability would result in a better proxy for cash rental payments than the proposed accounting.

We note that the Boards considered, and rejected, this approach, as described in the Basis for Conclusions.⁵ However, we agree with the view that the right-of-use asset and the lease payment obligation are inextricably linked, both at inception as well as on an ongoing basis, as the right-of-use asset cannot exist in isolation without the lease payment obligation. Accordingly, we urge the Boards to reconsider this alternative in their redeliberations.

⁵ Paragraphs BC8 to BC11.

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3. Financial statement presentation for lessees

The Proposal would eliminate the income statement caption “rent expense” for lessees and replace it with amortization expense relating to the right-of-use asset and interest expense on the lease payment obligation. We note that for commercial banks, net interest margin is a key metric used by investors to assess the profitability of the bank’s core business activities of accepting deposits and making loans. Accordingly, we are strongly opposed to including interest expense on lease payment obligations relating to non-core leasing activities (reflected as an asset and a liability on the lessee’s balance sheet) in net interest margin. We believe that including expenses related to ancillary activities in this key performance metric would reduce the usefulness of the financial statements for investors. We recommend instead that interest expense on lease obligations be permitted to be classified below net interest margin for financial institutions insofar as it relates to non-core leasing activities. If, on the other hand, leasing is identified as a core activity for a financial institution, we agree that it should be included in net interest margin.

In addition, we agree that the right-of-use asset should be included in property, plant and equipment in the statement of financial position, as this classification is consistent with the conceptual basis that the lessee effectively has possession of the asset during the lease term. In this regard, we suggest that the Boards modify the guidance in the Proposal to state:

25. A lessee shall present the following items in the statement of financial position:

(b) right-of-use assets ~~as if they were tangible assets~~ within property, plant and equipment, separately from assets that the lessee does not lease.

Similarly, we believe that the right-of-use asset should be tested for impairment in the same manner as property, plant and equipment, rather than as an intangible asset, and accordingly, we suggest that paragraph 24 be revised as follows:

24. A lessee shall apply Topic ~~350~~ 360 at each reporting date to determine whether the right-of-use asset is impaired and shall recognize any impairment loss in accordance with Topic ~~350~~ 360.

C. The Proposal should allow non-core leases to be accounted for as operating leases.

The Proposal would pose tremendous operational challenges for commercial banks. Commercial banks will have to inventory thousands of contracts and then, for each lease, categorize and remeasure it. The information required will exceed that required under current U.S. GAAP, and gathering and analyzing the information will take considerable time and effort. Furthermore, the requirement to reassess estimates when facts and circumstances change will

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entail significant incremental effort and judgment as compared to the current approach. This data-gathering exercise will include many leases that are clearly tangential to the core business activities of commercial banks, such as leases for copier equipment (as lessee), or the sublease of one floor of an owned or leased office building by a non-real estate investment company (as lessor).

To ease the significant operational burden of the Proposal, we strongly recommend that non-core leasing activities continue to be accounted for as operating leases by both lessees and lessors. In order to ensure a principles-based approach, non-core activities could be defined generally as those leases that are not essential to an entity's operations. Companies would then be required to identify core versus non-core activities for their particular business and fully disclose what is included in each category in the footnotes to the financial statements.

If the Board does not wish to adopt this approach, we believe that the Board should apply a scope exemption for short-term leases, rather than merely a simplified application. We appreciate the Boards' efforts to provide relief in the form of simplified accounting for short-term leases; however, we believe that the simplified application does not go far enough in easing the operational burden of the Proposal, as it would still require companies to compute the amount of the asset and liability, which is in and of itself fairly complex. We believe that a scope exemption is appropriate because we believe that the current accounting model is deficient primarily for longer-term leases where the distinction between a lease as opposed to a transfer of beneficial ownership is unclear. The current operating lease accounting model continues to be appropriate for very short-term leases and accordingly should not be abandoned.

Consistent with avoiding "bright line" distinctions in this area (such as a maximum 12-month lease term in defining "short-term leases") that may not provide sufficient relief to preparers, The Clearing House instead recommends that the Boards solicit feedback from preparers as part of field-testing to determine an appropriate definition of a "short-term lease".

D. A prospective transition approach for existing leases should be adopted

As discussed above, the Proposal poses significant operational burdens for our members. To ease these burdens, we strongly recommend that the scope of the Proposal only include leases existing at the initial adoption date and not apply to leases that terminated in comparative periods presented. Making a determination of what was "more-likely-than-not" in earlier periods would be extremely subjective and it would be hard not to use hindsight based on whether or not the lease was actually extended or not.

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In any event, in light of the complexities of implementing the requirements of the Proposal, the Boards must allow for a sufficiently lengthy amount of time to ensure that entities can fully understand and prepare for the regulatory implications of the new standard and implement the new requirements in a safe and sound manner.

Finally, we note that the transition provisions do not specifically address how sale-leaseback transactions from prior periods (and any deferred gains associated with such transactions) would be evaluated as of the date of initial application. We recommend such transactions be grandfathered, but with enhanced disclosures required where related amounts are material. A prospective transition approach would eliminate re-recognizing gains that may have already been recognized in a prior period.

Thank you for considering the comments provided in this letter. If you have any questions or are in need of any further information, please contact me at (212) 613-9883 (email: david.wagner@theclearinghouse.org) or Gail Haas at (212) 612-9233 (email: gail.haas@theclearinghouse.org).

Sincerely yours,



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