May 30, 2013

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

RE: File Reference No. 2012-260
Exposure Draft – Credit Losses

Dear Sir or Madam:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents federal credit unions, I write to you regarding the Financial Accounting Standards Board’s (FASB) exposure draft prescribing the treatment of credit losses. The exposure draft, generally, seeks to replace the current credit loss impairment model, which reflects incurred credit events, with an expected loss model. The expected loss model requires credit unions to consider forward-looking data and a broad range of “reasonable and supportable” information to inform credit loss estimates. NAFCU believes this proposal will have a negative impact on credit unions with respect to two issues: (1) it will result in an increase in credit union allowances, misleading members and potentially affecting credit union regulatory capital requirements; and (2) it will impose significant costs on credit unions by requiring increased data collection, implementation of proper recording systems, and the hiring and training of personnel to conduct the forecast.

I. Introduction

First and foremost, NAFCU would like to reiterate its position that in proposing new accounting standards updates, the FASB should take into account the unique structure of credit unions as member-owned not-for-profit cooperative entities. Credit unions aim to meet their members’ needs and provide quality service, not to generate profit. Accordingly, the primary reader of credit unions’ financial statements is the National Credit Union Administration (NCUA), not individual or institutional investors. As such, standards geared toward publicly held entities are often inapplicable or extremely difficult and costly to apply to credit unions.
As a part of its broader project to address the weaknesses identified in the current U.S. Generally Accepted Accounting Principles (GAAP) by the Financial Crisis Advisory Group (FCAG), the FASB instituted a comprehensive overhaul of accounting for financial instruments, comprising several accounting standards updates. In Recognition and Measurement of Financial Assets and Financial Liabilities, the FASB proposed linking the classification and measurement of an instrument to the extent to which an entity intends to collect its contractual cash flows. Under the credit losses proposal an entity must recognize a credit loss allowance equal to the present value of the cash flows not expected to be collected from an instrument. In doing so, it would replace the current incurred loss model with a forward-looking model that requires economic forecasting based on a broad array of new information.

II. Cost-Benefit Analysis

The costs for credit unions to implement this proposal, particularly with respect to performing a forward-looking analysis on all financial assets subject to credit risk, far outweigh any added value brought to the primary user of credit union financial statements – again, the NCUA.

The credit loss proposal’s underlying goal is to enhance investor confidence in the financial markets by improving financial loss reporting. Investors in large, complex financial institutions were unable to uncover non-performing assets hidden deep within intricate balance sheets, resulting in panic when losses mounted and institutions failed. In contrast, federal credit unions are typically small institutions premised on serving their local communities. They do not, and cannot, attract outside investors or shareholders. Furthermore, they submit detailed financial information to the NCUA, which closely monitors their financial health, and they participate in a government-operated liquidity facility to cover catastrophic losses in the event of a financial crisis. Thus the proposal would provide little, if any, benefit to credit union members.

The proposal would impose significant costs, however. Costs include: collecting and recording the necessary data; hiring and training personnel to conduct forward-looking analyses; and indirect costs. Currently, credit unions do not seek out or compile the vast majority of the information the proposal would require them to consider, particularly information regarding future economic conditions’ effects on historical loss experience. Credit unions also do not typically employ or contract personnel with the technical skills to engage in the advanced economic forecasting necessary to put the information to use. Many credit unions do not have the resources or economies of scale to enable them to obtain such information or personnel without impacting their services or returns to their members. On average, a credit union has $150 million in assets and 38 employees, with medians of $21 million and 6 employees, respectively. The industry simply cannot take on these costs. The proposal would also result in the indirect costs associated with losing members or deposits because of increased allowances creating a distorted depiction of the credit union’s health. Credit unions would also likely need to incur expenses to educate their membership as to why their allowances have increased so much and to mitigate any reputational harm. There is no added value to justify these costs of performing the required analysis.
A report conducted by the Securities and Exchange Commission (SEC) in 2008, detailing its study on mark-to-market accounting, also casts doubt on the need for additional and complex methods for recording impairments. Generally, the report called on the FASB to reassess current impairment accounting models for financial instruments. Specific recommendations included: (1) reducing the number of models for determining and reporting impairments; (2) considering whether the information available to investors would be improved by providing information about management’s expectations of an instrument’s underlying credit quality; and (3) reconsidering restrictions that affect the ability of entities to record increases in market value. The credit losses proposal runs directly contrary to the first and second recommendations.

The International Accounting Standards Board (IASB) also does not endorse the FASB’s proposed approach. Under the IASB’s March 7, 2013 proposal, an entity would record only a portion of its expected credit losses until significant deterioration had occurred. Only at that later stage would an entity be required to obtain a full estimate of expected credit losses. Compared to the FASB’s current proposal, the IASB’s approach would greatly reduce the costs imposed on entities and would be less likely to cause unwarranted concern among their investors.

America’s credit unions serve approximately 94 million people. As member-owned not-for-profit cooperative entities, credit unions aim to meet their members’ needs and provide quality service, not generate profit. Thus, every dollar they use to comply with regulations and accounting standards is a dollar they cannot use for the greater good of their members and the communities they serve. As such, complying with unnecessary and costly FASB requirements will directly negatively impact credit union members.

III. Increases in Credit Union Allowances

The exposure draft’s model would replace the incurred loss model currently required under GAAP, which does not require losses to be recorded until it is probable that an asset is impaired or a loss has been incurred, with an expected loss model.

The proposal will have a profoundly negative impact on the credit union industry. As a general matter, NAFCU does not believe artificially increasing the allowances on credit union balance sheets will help financial statement users obtain a more accurate depiction of credit unions’ financial health. Credit unions will likely have to significantly increase their allowance accounts under the proposal. This is particularly harmful because capital dedicated to offsetting allowance accounts is no longer available for a credit union to loan or return to its members, during a time when capital is still scarce in many communities.

Further, any increase in a credit union’s allowances would weaken the appearance of its balance sheet and may cause concern among its regulators for no legitimate reason. The credit union would not be any riskier of an institution into which members can deposit their money, but sudden and drastic increases in allowances could result in losses in regulator confidence, and therefore member deposits. Similarly, regulatory capital holding requirements could cause serious problems for credit unions. Importantly, policy makers are currently deliberating whether to impose such a requirement, which would be unprecedented for the credit union industry. Further, credit unions already face statutory restrictions on their ratio of net worth to
total assets. Ceteris paribus, an increase in a credit union’s allowances will reduce its net worth to assets ratio, in some cases resulting in serious regulatory consequences such as direct intervention by the NCUA. This is especially true because most credit unions do not have access to additional capital. Ultimately, the joint effect of members withdrawing their money because they are worried about the health of their credit union and an increase in capital requirements will have potentially disastrous effects on credit unions.

IV. Data Collection and Economic Forecast Costs

Under the proposal, when determining cash flows not expected to be collected on an instrument an entity must consider a variety of new information. The information includes: historical loss experience with similar assets; current conditions; and, reasonable and supportable forecasts and their implications. Further, entities must consider quantitative and qualitative factors specific to borrowers and the economic environment in which the entity operates, as well as an evaluation of the likely direction of both the current and future economic cycles.

The proposal is problematic for several reasons. First, the proposal would require credit unions to increase the amount of data they collect and change the type of data collected. Credit unions do not currently compile or request the majority of information listed in the proposal and do not have an established recordkeeping system for such information. The FASB stated that they believe that in practice many of the commonly used approaches to credit losses are already consistent with the expected loss approach. This was based on the fact that many measurement methods currently in place under the incurred approach rely on an extensive population of actual data on collection and losses. Further, the FASB believes that these methods are already typically relying on the statistical mean, the average outcome, rather than the statistical mode. This is simply not true. Our member credit unions have expressed that they do not already request and record the majority of the type of data to be considered in the forward-looking analysis under this proposal under the current incurred loss approach.

Second, according to the most recent FASB podcast on the credit losses proposal, the FASB expects the forward looking projections to largely be informed by historical experience for similar assets. However, this historical experience will need to be updated by an entity’s current assessment of existing conditions. This new two-tier analysis will require significant resources and trained personnel to perform. Many credit unions lack such personnel to both intake the data and to utilize it to conduct economic forecasting. Hiring, training, and retaining such personnel would be time consuming, expensive, and potentially difficult for smaller, rural and underserved area credit unions.

Third, it is unlikely that even with such information an entity could create a meaningful or useful prediction of cash flows that it will not collect. Although past and current known events have a high degree of usefulness, reasonable economists can differ greatly in their predictions of future credit losses. Any such predictions would be highly subjective, as the range of information set forth in the proposal is both broad and varied. Because they would be highly subjective, industry regulators would be unable to examine fairly all the measurements used to project credit impairments among entities and understand why their financial results differ.
In sum, the added value brought to the user of a credit union’s financial statements simply does not justify the cost of performing a forward-looking analysis on all financial assets subject to credit risk.

V. Troubled Debt Restructurings

NAFCU requests that the FASB provide greater flexibility for deferring recognition of economic concessions granted by a credit union. In particular, the FASB should afford greater latitude for troubled debt restructurings, in which a credit union tries to maximize its recovery of an instrument’s original contractual cash flows. Credit unions, as member-owned cooperative nonprofits, make every effort to help members who have trouble paying their loans. Credit unions should have additional options for accounting for such concessions made to restructure member debt, especially because of the vital importance of credit availability in underserved communities.

VI. Time Limit on Projections

The current exposure draft would require a credit union to estimate credit losses over the entire contractual term of the financial asset. This is highly impractical, given the unpredictability of the economic climate and conditions affecting the credit union industry. Therefore, NAFCU suggests that if this proposal is adopted, the requirement to consider forward-looking losses should be limited to predicting what an entity expects to occur during its next annual reporting cycle. Although even this may prove difficult due to the subjective nature of the forecasting, it would greatly enhance the accuracy of the forecasting and reduce the burden of conducting the forecast.

The FASB has expressed its concern that in order to be “representationally faithful,” entities must prove an estimate of periods beyond the foreseeable future. Further, the FASB does not believe it is representationally faithful to assign a zero to credit losses of distant periods simply because an entity is unable to precisely estimate future economic conditions for those periods. NAFCU agrees that assigning a zero to credit losses for these distant periods would be misleading, but believes that so too would be allowing users of financial statements to rely on projections of economic conditions so far in the future that they have little basis to support them. Entities should be able to draw a distinction between saying there are no expected credit losses and disclosing that they do not yet know enough to project expected credit losses. As such, NAFCU believes that entities should be permitted to limit the projection of an asset’s expected credit losses to its next annual reporting cycle and disclose that it would be premature to make any predictions beyond that point.

VII. Recovery

Although NAFCU does not support the proposal to the extent that it unnecessarily increases credit loss allowances for credit unions, NAFCU does support recognition of credit losses for debt securities as allowances rather than permanent write-offs and the opportunity for recovery of credit losses upon receipt of consideration. Under current U.S. GAAP, there is no
opportunity for such recovery for debt securities. The proposal would create additional flexibility for credit unions to improve their balance sheets by continuing to work closely with their members.

VIII. The Collateral-Dependent Method

NAFCU strongly supports the FASB’s proposal to retain the use of the collateral-dependent method for assets that are collateral dependent. The proposal notes that this method is acceptable as a practical expedient if the obligation is expected to be satisfied by the operation by the lender or by the sale of the collateral, and broadens the definition of collateral dependent. It also removes a requirement to use the collateral-dependent method, adding flexibility, especially during times of foreclosure. The collateral dependent method is especially important to credit unions because mortgages, loans secured by collateral, make up the majority of credit unions’ business. This proposal would thereby greatly increase the efficiency and simplicity of credit unions’ required calculations.

IX. Alternative solutions

NAFCU proposes that as an alternative to the FASB’s expected credit loss proposal it instead impose a disclosure regime. Under such a regime, entities would advise users of their financial statements as to the exact methods the entity employed to forecast its allowance for credit losses. For example, a credit union using an incurred loss method based only on current and historical information would include a description of this method in the section of its financial statements discussing its credit loss allowances. Entities choosing to engage in a forward-looking analysis could include the economic factors included and assumptions made, as well as information regarding any troubled debt restructuring programs and potential for recovery. Such a regime would accomplish the FASB’s goals of transparency and enhancing investor confidence in financial markets while at the same time avoiding balance sheet distortion and costly changes to industry practices.

X. Conclusion

The FASB’s stated goal of its credit losses proposed accounting standard update is to give financial statement users a more accurate depiction of credit risks. However, for the reasons stated above, not only will the proposal not generate improved information for financial statement users, but it will have a uniquely negative impact on the credit union industry. As member-owned cooperatives that are not publicly traded, credit unions should not be subject to this rule.

If the FASB does decide to apply the standard to credit unions it should consider that it will be a very costly and difficult proposal to implement and the FASB should take steps to significantly mitigate its impact. The FASB sought comment on whether early adoption should be permitted and whether there should be a delayed effective date for nonpublic entities. Credit unions should be given additional time to create the proper recordkeeping systems, and to hire and train personnel to comply with the forecasting requirements under this proposal.
If the FASB chooses to put credit unions under the purview of this proposal, NAFCU urges the FASB to streamline and simplify the method for calculating credit losses wherever possible. Further, NAFCU urges the FASB to continue to harmonize its proposals with existing rules promulgated by the NCUA and other prudential regulators’ guidance as much as possible. This both promotes consistency and levels the playing field for regulated and non-regulated entities.

NAFCU appreciates the opportunity to provide our comments. Should you have any questions or concerns, please feel free to contact me at ameyster@nafcu.org or (703) 842-2272.

Sincerely,

Angela Meyster
Regulatory Affairs Counsel