Friday, May 31, 2013

Dear Director,

Thank you for the opportunity to comment on the Exposure Draft for proposed changes to Accounting Standards Subtopic 825-15, Financial Instrument Credit Losses. In general, there are many parts of the proposal I am opposed to but I will limit the content of this letter to a few of the most significant issues. In this response I would like to address questions regarding the proposal's ability to improve information for the investment decision process, preparation of the reserve calculation and disclosure of the supporting assumptions.

It is my belief that the proposed changes would not provide investors with better information for decision making or other stakeholders with a better perspective of an organization's financial position.

I understand the desire to remove volatility from the Allowance for Loan & Lease Losses (ALLL) account with the objective of producing a more reliable set of Financial Statements. Unfortunately the proposed Current Expected Credit Loss (CECL) model will not reduce volatility and at the same time provide an accurate representation of an entity's position any better than the current model. Take for instance, the moment at which the Financial Crisis began- I identify that as September 2008. Had the CECL model been in place, how would it have proven more useful at that time? The economic conditions during the few months leading up to and few months immediately following September 2008 did not change dramatically enough to remotely indicate the magnitude of future losses. If any entity had sufficient reserves to cover future losses at the end of any month immediately after September 2008, then I would assert at any time prior to September 2008 that entity would most definitely be over-reserved in their ALLL account. Furthermore, in such severe circumstances as the recent Financial Crisis, I assert we should see unusual changes in credit loss reserves suitable for an unusual economic environment. As experienced during the Financial Crisis, increasing the reserve balance as losses increase demonstrates a decline of the credit quality within the current environment. Similarly, as the credit quality within the environment stabilizes, lower credit losses can be expected. A reduction in volatility with regard to ALLL reserves during extreme economic environments can only come at the cost of accuracy and reasonableness. The current incurred loss model (with coverage of delinquent loans as a litmus test) provides adequate reserve balances.

Even amateur investors I've encountered have a basic understanding of the cyclical nature of the current historical loss ratio calculation used to determine the ALLL reserves. The proposed Current Expected Credit Loss (CECL) model would require investors to research all the underlying assumptions used to estimate what the Allowance account balance should be so they can understand the methodology and make an assumption about its validity.
And the investor would be required to repeat this process for every financial institution of interest. With a few exceptions, Financial Statements have mainly been a reflection of an entity’s prior performance. I agree with others who have published comments suggesting Financial Statements retain the objective of reporting completed events, thereby leaving assumptions and predictions to analysts.

The current method for calculating credit losses is not perfect. However, discounting future cash flows or other means of prediction does not result in increased accuracy.

When producing the calculation, the CECL model encourages less emphasis on historical information which in turn means there is a more ambiguous management interpretation of environment and other qualitative factors. The reduced reliance on historical losses in reserve calculation reduces the beneficial impact of solid credit decisions during the underwriting process which today can significantly influence the degree of losses an institution experiences. Subsequently this puts more emphasis on assumptions which opens the door for management manipulation. Auditors are expected to attest to the legitimacy of Financial Statements. Historically, their role has not been to tenaciously assess assumptions. Therefore, I’m concerned about their ability as a group to challenge assumptions with the determination necessary to scrutinize such a considerable component of the balance sheet. For these reasons, I suspect reducing the impact historical loss ratios (facts) have on the ALLL reserve could allow and encourage management to produce instances where the reserve balances between competing institutions is similar, yet the credit risk is in reality substantially different.

Disclosure sets have increased in complexity in recent years. The implementation of this proposal would increase complexity once again. There is not sufficient benefit to support the additional cost for the entity to produce these disclosures AND additional cost for the analyst/investor to evaluate these disclosures. The most recent credit quality disclosure requirements have only been fulfilled once (year-end figures for 3 periods and displaying year-over-year change) with the close of 2012. The adequacy of these disclosures could not have been fully evaluated by the release of this Exposure Draft. It would be unfortunate (and a bad habit for FASB to adopt) to dismiss these disclosure requirements without evidence that the replacement disclosures add value.

Finally, with regard to my employer’s segment of the financial services industry, the exercise of producing valuable financial statements for “investors” is minimized because Credit Unions don’t have investors. There are however many stakeholders. The majority of these stakeholders possess the acuity to understand the current flow of loan loss reserve calculations. The same can be said for our regulators at the National Credit Union Administration. Under the CECL model, the reserve calculation complexity is increased beyond the point of value achieved. This increased complexity and minimal benefit will adversely impact (sub “at best impair”) the stakeholders that are required to understand the ALLL reserve component of Financial Statements and influence the success of my organization.

In closing, I thank you for reviewing these comments as you evaluate the ramifications of the Exposure Draft related to Standards Subtopic 825-15. I hope my assertion that the proposed CECL model will not provide more useful information to investors or a simpler means of calculation is valuable to the Financial Accounting Standards Board in its final decision on applying content as describe in the Exposure Draft.

Regards,

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