Re: Proposed Accounting Standards Update, Financial Instruments - Credit Losses (Subtopic 825-15)

Liberty Mutual Group (LMG) is a diversified global insurer and the sixth largest global Property and Casualty (P&C) insurer in the world. As of December 31, 2012, LMG has approximately $120 billion in consolidated assets and $102 billion in consolidated liabilities. Our consolidated revenues were approximately $37 billion for the year ended December 31, 2012. LMG has an interest in the proposed impairment model both as an investor, with an investment portfolio of over $72 billion as of December 31, 2012, and as a preparer of U.S. GAAP financial statements.

We appreciate the opportunity to provide the Financial Accounting Standards Board ("FASB") with our comments pertaining to the Proposed Accounting Standards Update, Financial Instruments - Credit Losses (Subtopic 825-15) issued on December 30, 2012.

We previously submitted a comment letter in April 2011, on the joint FASB/IASB Supplementary Document, Financial Instruments: Impairment, and note that this proposal has been withdrawn with FASB and the IASB now issuing revised and differing credit impairment proposals. We reiterate our previously expressed views that for debt securities we are supportive of the incurred loss model in current US GAAP. We view the current impairment model for debt securities, which was improved during the financial crisis, as being very effective and we are concerned that the Board is proposing that a loan impairment model be applied to securities. We do not understand why the FASB is undertaking this project. The U.S. has good working guidance and we cannot comprehend why changes are needed. Additionally, the FASB has historically disallowed general allowances but now seems to believe general allowances are warranted. The current impairment model for debt securities provides for timely recognition of credit losses, and expected credit loss information could be provided using credit quality disclosures.
In addition, this is the third attempt by the FASB to fix a problem that does not exist. This alone should tell the FASB that you should not fix something that is not broken.

Should the FASB decide to adopt the model as proposed in the exposure draft, we would urge the Board to consider our comments as detailed below.

Overall comments on the FASB proposal

When a financial asset is priced on market terms at initial recognition, we do not believe it is appropriate to subsequently establish an expected credit loss allowance when there has been no significant increase in credit risk since initial recognition. In particular, we do not believe that the recognition of lifetime expected losses under the Current Expected Credit Loss ("CECL") model is appropriate for debt securities carried at fair value through other comprehensive income (FV-OCI). The fair market value of these assets already includes a factor for expected losses and as such recognition of a further allowance introduces double-counting. The issue of "too little, too late" does not apply to securities that are measured at fair value. In addition, except for those securities that meet the practical expedient (which will probably be infrequent), we do not understand why in reviewing impairment, a company would have to consider a probable loss for every security.

Scope

We do not support the inclusion of reinsurance recoverables or trade receivables within the scope of the ASU and recommend they remain within the scope of ASC 944. We note that the IASB’s proposal does not include reinsurance recoverables.

We also do not support the inclusion of FV-OCI assets in a standard that principally addresses loan impairment.

Practical expedient

We agree with the objective of the practical expedient for FV-OCI assets (though in current form, we believe it will only be used in limited circumstances); however we recommend changing the guidance so that a practical expedient can be used if either (1) the fair value of the financial asset is greater than (or equal to the amortized cost basis) or (2) expected credit losses on the financial asset are insignificant. This would reflect the fact that changes in market interest rates can move the fair values of debt securities below amortized cost even when there is no change in underlying credit risk and would allow for no allowance on highly rated securities.

Operational & Other Concerns

It is likely that entities not currently involved in lending activities will incur significant financial and operational costs to implement additional policies, processes and controls in order to comply with the proposed accounting model. The proposed accounting model requires impairment calculations to incorporate forecasts of future events and economic conditions, which is very subjective and likely to cause comparability issues between financial statements. Each entity will
interpret 'reasonable and supportable forecasts of future events and economic conditions' differently, making it difficult to compare financial statements across entities and industries. Further, an entity's evaluation of the reasonableness of its forecasts may differ from evaluations by third parties (i.e., auditors, regulators, etc.) based on information available to each. Exactly how does an auditing firm audit forecasts? Auditors are in the business of auditing history. These items will present challenges for both the entity and third parties in supporting and auditing future forecasts.

Comparison with the IASB proposal

Though we believe the current FASB model is the best approach, the IASB credit impairment model is preferred over the GAAP proposal. The IASB model at least requires significant credit deterioration for debt securities must occur before lifetime expected losses are recognised. We believe this model is more preferable than the proposed GAAP model for securities and loans purchased or originated at fair value as it is it is more reflective of an incurred loss approach than the CECL model.

Effective Date

Current systems used to account for management of insurance company investments would require significant adjustments to programming in order to track and account for assets and related expected credit losses under the proposed model. We believe a time period of 18-24 months would be appropriate to allocate resources and make system changes.

We believe it is also critical that the effective dates for all proposals affecting insurance company accounting (financial instrument guidance and insurance contract guidance) be aligned to assure appropriately coordinated systems adjustments, asset-liability management decisions and reporting.

In addition to the comments expressed herein we have also expanded our responses in the appendix attached.

Sincerely,

John Doyle
Vice President & Comptroller
Liberty Mutual Group
Appendix - Questions for Respondents

Scope

Question for all Respondents

Question 1: Do you agree with the scope of financial assets that are included in this proposed Update? If not, which other financial assets do you believe should be included or excluded? Why?

No. We do not support the inclusion of reinsurance recoverables or trade receivables within the scope of the ASU and recommend they remain within the scope of ASC 944. We would also note that the IASB’s proposal does not include reinsurance recoverables. We believe it should be a priority for the FASB and IASB to agree on scope for both the impairment proposals and the insurance contracts standard. Under this proposal, a company would set up a reinsurance allowance when a loss happens regardless of the reinsurer’s credit rating or collateral held. Why would an allowance be recorded for companies that have never missed a payment or, look at it on the other side, when a company insures directly, are they setting up an allowance due to the collectability of the direct insurer? That makes little or no sense.

We also do not support the inclusion of FV-OCI assets in a standard that principally addresses loan impairment.

Recognition and Measurement

Questions for users

Question 2: The proposed amendments would remove the initial recognition threshold that currently exists in U.S. GAAP and, instead, view credit losses as an issue of “measurement” as opposed to an issue of “recognition” because the credit losses relate to cash flows that are already recognized on the balance sheet. Do you believe that removing the initial recognition threshold that currently exists in U.S. GAAP so that credit losses are recognized earlier provides more decision-useful information?

No. We believe the current impairment model for debt securities provides for timely recognition of credit losses. We do not believe the proposal will provide more decision-useful information due to the lack of comparability across entities. We also believe the proposal introduces the element of double counting of allowances for assets purchased or originated at market prices and carried at fair value.

Question 4: The Board has twice considered credit loss models that would permit an entity not to recognize certain expected credit losses. In the January 2011 Supplementary Document, the Board considered a model that would permit an entity not to recognize some credit losses expected to occur beyond the foreseeable future. In the recent discussions on the three-bucket impairment model, the Board considered a model that would permit an entity only to recognize lifetime credit losses for loss events expected to occur within a 12-month horizon. Instead, the proposed amendments would require that at
each reporting date an entity recognize an allowance for all expected credit losses. Do you believe that recognizing all expected credit losses provides more decision-useful information than recognizing only some of the expected credit losses? If not, how would you determine which expected credit losses should not be recognized (for example, 12 months or similar foreseeable future horizon, initial recognition threshold, and so forth)?

We believe that only when a significant credit-related event has occurred should a credit loss be recognized, at an amount supportable by current information available. What this question shows is that the FASB is reaching to fix a problem that does not exist. This is the third attempt and the FASB still cannot explain what the problem is with the current method or why any of the proposed suggestions are better than the current methodology.

**Question 5:** The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial assets' remaining contractual cash flows. Do you believe that expected credit losses based on this information provide decision-useful information?

No. We do not believe the proposal will provide more decision-useful information due to the lack of comparability in forecast assumptions across entities.

**Question 6:** For purchased credit-impaired financial assets, the proposed amendments would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be amortized into and recognized as interest income over the life of the asset. To achieve this result, upon acquisition the initial estimate of expected credit losses would be recognized as an adjustment that increases the cost basis of the asset. Apart from this requirement, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired assets and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you believe that using the same approach to recognize changes in the credit impairment allowance for purchased credit-impaired assets and non-purchased-credit-impaired assets provides decision-useful information? Do you believe that this is an improvement from the current model used for purchased credit-impaired assets?

No. The proposed accounting would treat credit improvements subsequent to acquisition as an immediate reduction in the provision for credit losses even though the original allowance was treated as a gross up to the balance sheet and not recognized through income. We recommend keeping existing accounting for PCI assets under which favorable changes in credit losses that are in excess of the allowance are treated as prospective yield adjustments. There is also a concern that initial overstatement of the expected credit loss could lead to inappropriate releases of the allowance to income when improvements to the forecasted cash flows are recognized.
Question 7: As a practical expedient, the proposed amendments would allow an entity not to recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost amount of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. The proposed amendments would require an entity to disclose the amortized cost basis of assets that apply this practical expedient each period. Do you believe that the practical expedient for some financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income is reasonable? Why or why not?

No. We recommend a practical expedient which can be used if either (1) the fair value of the financial asset is greater than (or equal to the amortized cost basis) or (2) expected credit losses on the financial asset are insignificant. This change would reflect the fact that market interest rates can move the fair values of debt securities below amortized cost while there is no change in underlying credit risk and would allow for no allowance for highly rated securities.

Questions for Preparers and Auditors

Question 9: The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectibility of the financial assets' remaining contractual cash flows. Do you foresee any significant operability or auditing concerns or constraints in basing the estimate of expected credit losses on such information?

Yes. We foresee significant operational and auditing concerns and constraints. We have not historically collected total credit loss experience data on debt securities. A limited number of years' impairment charges are available but recoveries of impairments are not. We would not necessarily rely on industry data to forecast expected losses as it may not reflect our specific experience. As such a significant effort will be required to rebuild historical data and build a controlled, sustainable forecasting model. Auditability of valuations is a significant concern as we move to a model that includes forecasted expectations. As previously mentioned, how exactly are auditors auditing forecasts?

Question 10: The Board expects that many entities initially will base their estimates on historical loss data for particular types of assets and then will update that historical data to reflect current conditions and reasonable and supportable forecasts of the future. Do entities currently have access to historical loss data and to data to update that historical information to reflect current conditions and reasonable and supportable forecasts of the future? If so, how would this data be utilized in implementing the proposed amendments? If not, is another form of data currently available that may allow the entity to achieve the objective of the proposed amendments until it has access to historical loss data or to specific data that reflects current conditions and reasonable and supportable forecasts?
As noted above in question 9, we have not historically collected credit loss experience data on debt securities. We would not necessarily rely on industry data to forecast expected losses as it may not reflect our specific experience and so we believe we would need to develop our own model and processes.

**Question 11:** The proposed amendments would require that an estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results. This proposal would prohibit an entity from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode). As described in the Implementation Guidance and Illustrations Section of Subtopic 825-15, the Board believes that many commonly used methods already implicitly satisfy this requirement. Do you foresee any significant operability or auditing concerns or constraints in having the estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results?

Yes. For highly rated FV-OCI debt securities, or highly rated structured securities, models will be required to include unrealistic assumptions in order to generate some measure of credit loss to comply with the standard. This appears counter-intuitive to the goal of producing useful financial information.

**Question 14:** As a practical expedient, the proposed amendments would allow an entity to not recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. Do you foresee any significant operability or auditing concerns or constraints in determining whether an entity has met the criteria to apply the practical expedient or in applying it?

No, but we recommend a practical expedient which can be used if either (1) the fair value of the financial asset is greater than (or equal to the amortized cost basis) or (2) expected credit losses on the financial asset are insignificant. This change would reflect the fact that market interest rates can move the fair values of debt securities below amortized cost while there is no change in underlying credit risk. The current proposal would require estimation of credit losses where changes in fair value are solely driven by market interest rates.

**Questions for Preparers and Auditors**

**Question 18:** Do you foresee any significant operability or auditing concerns or constraints in complying with the disclosure proposals in the proposed Update?

As preparers of financial statements we foresee significant operability issues. We have not historically collected total credit loss experience data on debt securities. A limited number of years' impairment charges are available but recoveries of impairments are not. We would not necessarily rely on industry data to forecast expected losses as it may not reflect our specific experience. As such a significant effort will be required to rebuild historical data and to test and
build a controlled, sustainable forecasting model. Auditability of valuations is a significant concern as we move to a model that includes forecasted expectations.

Implementation Guidance and Illustrations

Questions for All Respondents

Question 19: Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient? If not, what additional guidance or examples are needed?

No. There is no guidance around how the expected credit loss allowance would be booked for FV-OCI assets. There also needs to be more guidance around transition issues such as accounting for existing PCI assets, previously impaired securities and TDRs.

Transition and Effective Date

Questions for All Respondents

Question 20: Do you agree with the transition provision in this proposed Update? If not, why?

Yes, however there needs to be more guidance around transition issues such as accounting for existing PCI assets and TDRs.

Question 22: Do you believe that the effective date should be the same for a public entity as it is for a nonpublic entity? If not, why?

No. Private companies will require additional time to implement models, systems and processes.

Questions for Preparers and Auditors

Question 23: Do you believe that the transition provision in this proposed Update is operable? If not, why?

No, there is no guidance around how the expected credit loss allowance would be booked for FV-OCI assets. There also needs to be more guidance around transition issues such as accounting for existing PCI assets, previously impaired securities and TDRs.

Question 24: How much time would be needed to implement the proposed guidance? What type of system and process changes would be necessary to implement the proposed guidance?

We estimate a period of 18-24 months would be needed for implementation. We have not historically collected total credit loss experience data on debt securities. A limited number of
years' impairment charges are available but recoveries of impairments are not. We would not necessarily rely on industry data to forecast expected losses as it may not reflect our specific experience. As such a significant effort will be required to rebuild historical data and to test and build a controlled, sustainable forecasting model and related processes.