

March 31, 2011

Leslie Seidman, Chairman Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Sir David Tweedie, Chairman International Accounting Standards Board First Floor 30 Cannon Street London, EC4M 6XH United Kingdom

Re:

FASB File Reference No. 2011-150 Supplementary Document - Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging

Activities: Impairment

IASB Supplementary Document: Financial Instruments: Impairment

Dear Chairman Seidman and Sir David Tweedie:

The PNC Financial Services Group, Inc. (PNC) appreciates the opportunity to comment on the Supplementary Document Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment (SD).

## **General Comments**

PNC supports the efforts of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to develop improved accounting for the recognition and measurement of impairment for financial instruments. And, we appreciate the desire to issue a converged final standard as quickly as possible. As discussed more fully below, we agree with several concepts presented in the SD. Also discussed below, are our recommended changes to the proposed model as well as our recommended model for the Boards' consideration.

Because impairment accounting is so significant, we strongly believe the standard must reflect accounting that is reliable and relevant, operational, and that will be consistently applied. Accordingly, the financial, operational, and regulatory impacts of the SD must be thoroughly vetted prior to issuance of a final standard. We urge the Boards to allow sufficient time for an appropriate evaluation of any proposed impairment recognition and measurement accounting.

We believe it is more important to take the time needed to develop a high quality accounting standard than to rush to finish the standard.

Attempting to understand the proposed accounting, its potential financial impact, as well as its operationality requires modeling (including the processes to develop such models) which must be applied to a variety of portfolios for a number of different economic circumstances. A two-month comment period (January 31<sup>st</sup> through April 1, 2011) was not a sufficient amount of time for PNC to conduct this testing process. Because this process is essential to provide the most meaningful feedback on the SD, we strongly recommend extending the comment letter deadline. With the time provided by this extension, among other findings, we will be able to expand our understanding of:

- any operational difficulties in segmenting portfolios into good and bad books as defined in the SD;
- the concept of foreseeable future and how it may be applied to various portfolios and under various economic circumstances;
- the comparison of the higher of foreseeable future and time proportional amounts;
- the ability to apply the proposed model to a variety of instruments, including loans and investment securities;
- whether the proposed model can be applied to individual instruments and closed portfolios

Additionally, we note that the Boards request feedback on the proposed model as applied in a variety of circumstances; however, the SD is very limited in scope as it addresses only impairment recognition on open portfolios. The SD does not address closed portfolios; individual instruments; methods for measuring impairment; acquired instruments; troubled debt restructurings; interest revenue recognition; and other related topics. We believe an impairment standard must address these topics and we strongly believe the Boards must reexpose a complete impairment proposal to allow entities the opportunity to fully understand and analyze proposed impairment guidance and provide meaningful feedback. Based on the limited scope SD and the limited amount of time we have had for testing the SD concepts, we provide the following comments.

## Our Evaluation of the Proposed Impairment Model

We support modifying current accounting standards to allow an entity to record credit reserves without the limitation of the probable threshold as we believe the probable criterion delayed the recognition of reserves prior to the financial crisis. We believe a threshold of reasonably possible is a more appropriate threshold for determining impairment as it is consistent with expected losses that incorporate projections of events that can be reasonably estimated and support.

We have the following concerns regarding the proposed impairment guidance:

## Analysis of the Two-Calculation Approach

With regard to good book assets, the SD proposes that entities would record credit reserves based on the higher of the foreseeable future amount or the time-proportional calculation. We are concerned with this aspect of the proposal as we believe there is no conceptual accounting basis for determining a reserve based on a comparison of the foreseeable future and the time proportional calculation. Further, we believe reporting reserves segmented by "good book – foreseeable future" and "good book – time proportional" will be confusing to financial statements users and it is unclear how those financial statement users will view these reserves. For example, will financial statement users view "good book – foreseeable future" as lower credit quality than "good book – time proportional"?

In our modeling of home equity lines and loans under the proposed model in the SD, we noted that the foreseeable future amount is greater than the time-proportional amount. Although further validation of the two-calculation approach under additional economic scenarios and on other portfolios will not be known without additional time for modeling, based upon our work to date we believe it is likely the foreseeable future amount will exceed the time-proportional amount. Accordingly, we generally believe that the time-proportional calculation is unnecessary. However, it is possible that during lengthy periods of a favorable economic environment and benign credit, the time proportional amount will exceed the foreseeable future for a number of reasons, including the weighted average life of the portfolio and the timing of the expected losses. Therefore, if the two-calculation approach is retained, we believe it must be simplified to allow entities the ability to qualitatively analyze portfolios and apply one calculation.

## Definition of Bad Book

The SD defines a bad book asset as one in which the collectability "becomes so uncertain that the entity's credit risk management objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset". Current accounting standards require recording impairment at the point when an entity determines that it is probable it will not collect all principal and interest payments contractually due. We believe this criterion should be used to define bad book assets as it is consistent with a change in risk management objective to recovery of the asset, well understood, and consistently applied.

Paragraph B3 provides several examples of activities related to recovery of all or a portion of the financial asset which include: enforcement of security interests (e.g. foreclosure on real estate or seizing assets under collateral agreements); debt restructuring; and attempting to recover cash flows from an uncollateralized financial asset by making contact with the debtor by mail, telephone or other methods. These examples represent a broad spectrum of credit-related activities some of which occur after the point at which the credit risk objective for the asset has changed (i.e. foreclosing or seizing assets) and others which occur prior to the point which the credit risk objective has changed (i.e. contacting a debtor by telephone). We believe the definition of bad book and these activity examples could lead to inconsistencies in the application and interpretation of bad book assets. As noted above, we believe current GAAP is appropriate for the identification of these types of assets.

Assets are to be transferred between good and bad books based on how the assets perform resulting in the transfer of a good book asset, when it meets the definition of a bad book asset, to the bad book. However, we note the SD lacks a definition of when a bad book asset should be considered a good book asset and transferred to the good book. We propose that definition should be consistent with current practice; that is, when an asset has performed per the current contract for a period of time such that it can be reasonably concluded future principal and interest payments are collectible.

## Applicability of Model to All Financial Instruments

## Measurement of Impairment

The SD lacks discussion with regard to the measurement of impairment; however, we believe any future proposal must allow for a variety of methods for determining expected credit losses based upon a best estimate. Entities should have the ability to select impairment measurement methods based on what is appropriate for the subject asset. Allowable methods should, at a minimum, include: observable market price of the instrument; fair value of underlying collateral; and projections of expected cash flows including credit support. For investment securities, impairment could be measured based on an evaluation of the creditworthiness of the counterparty, or certain guarantors (i.e., agencies such as FNMA), as this method is commonly used when assessing impairment of, for example, U.S. Treasury securities.

When considering bad book assets, we do not support the SD's proposal to allow entities a choice between discounted and undiscounted cash flows, nor do we believe that entities should be able to choose a discount rate among a wide range of rates. We strongly believe this would lead to significant inconsistency and would result in incomparability among companies' financial statements. We believe there is sound accounting and economic basis for retaining current accounting guidance which requires discounting of cash flows at an instrument's effective rate when measuring impairment. However, if the Boards elect to allow entities a choice between undiscounted and discounted cash flows, we believe undiscounted cash flows should be applied to an evaluation of principal-only expected credit losses.

# Applicability of Model to Individual Instruments and Closed Portfolios

The SD does not discuss the model as applied to individual instruments or closed portfolios. We believe the model could be applied to closed portfolios and we strongly believe there should be no difference in impairment measurement based on whether the instrument is originated or acquired. Therefore, we recommend that the current SOP 03-3 accounting guidance for acquired instruments with credit impairment characteristics is eliminated upon issuance of final impairment guidance.

## Interest Revenue Recognition

We continue to support accounting for and reporting interest cash flows separate from principal cash flows as we believe investors find value in distinctly presenting interest and principal in the financial statements. In addition, we encourage the Board to propose guidance which is consistent with current interest revenue recognition practices including nonaccrual practices.

## Troubled Debt Restructurings

We believe the special accounting guidance related to troubled debt restructurings should also be eliminated upon issuance of a final impairment standard as we believe there should not be a different standard for impairment measurement for modified instruments. We acknowledge that financial statement users have an interest in the modification programs of entities and recommend that entities disclose modification programs, the numbers of and amounts of instruments that have been modified, and the impact of these modifications.

## Our Proposal for Recognition and Measurement of Impairment

We understand the goal of developing an impairment standard which permits entities to recognize credit reserves sooner in the credit cycle. However, we believe current accounting guidance with modifications can accommodate this goal without requiring adoption of the SD proposed model. Therefore, we offer the following as an alternative to the SD proposed approach for recognizing impairment.

As described in detail in the letter submitted by a number of U.S. banks, our proposal expands on existing incurred loss practices found within current accounting principles to more effectively estimate inherent credit losses by eliminating the probability threshold, incorporating expected events into the loss forecast and extending the loss emergence period. Under our proposal, inherent credit losses are estimated using a two-step approach. Although described in two steps, these two components – a Base Reserve and a Credit Risk Adjustment - are interrelated and are each necessary to estimate losses inherent in the portfolio.

We support the approach described in the separate comment letter which, we believe, allows entities to record credit reserves earlier in the loss emergence period and at amounts reflective of losses inherent in portfolios. We encourage the Boards to consider this proposal as we believe it is superior to other models proposed.

Our responses to the Boards' specific questions are detailed below.

#### Question 1

Do you believe the proposed approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

#### Response

We support the elimination of the probable threshold as we believe this criterion contributed to the delayed recognition of credit losses. Further, we believe credit reserves should be based on expected future losses determined based on a variety of factors including expected events. However, as discussed above, we believe the proposal in the separate comment letter response is a better impairment solution than that proposed by the SD.

### Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

#### Response

We are uncertain whether the SD approach could be applied to all types of individual instruments. However, as discussed above, we emphasize that the guidance should allow entities to choose the most appropriate method for determining expected losses. Also, in the interest of one impairment model, we believe the existing SOP 03-3 guidance should be eliminated when a final impairment standard is issued.

#### Question 3

Do you agree that for financial assets in the 'good book' it is appropriate to recognize the impairment allowance using the proposed approach described above? Why or why not?

### Response

See our general comments above in which we refer to the separate comment letter submitted by a number of banks.

## Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

## Response

As discussed above, we believe the approach for determining impairment on good book assets must be simplified so that entities are required to perform only one calculation.

#### Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

## Response

We believe the proposal in the separate comment letter response submitted by a number of banks would enhance financial statement users' understanding of reserves.

## Question 6

Is the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

#### Response

As discussed in our comments above, we believe the definition of bad book should be consistent with current accounting guidance as this guidance creates a clear distinction between a "good" and "bad" instrument, is well understood, and is consistently applied. Further, because entities' practices and processes have been developed around this guidance, retaining the current definition for "bad" book assets would avoid unnecessary operational challenges.

## Question 7

Is the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

#### Response

As discussed above, we support the current definition of an impaired instrument to be used as the definition of a "bad book" asset. Absent, the current definition, we believe entities may be forced to make significant and unneeded changes in credit practices in order to accommodate the proposed definition of "bad book".

### Question 8

Do you agree with the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

#### Response

We do agree with segmenting portfolios into good and bad books for the purpose of determining impairment. Further, we agree that the entire amount of expected losses should be recorded immediately for portfolios which meet the definition of bad book.

#### Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this proposed model. Specifically, on the following issues:

- (a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?
- (b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?
- (c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?
- (d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?
- (e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.
- (f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognized under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

## Response

- (a) We do not support bright line thresholds for a foreseeable future floor.
- (b) We do not believe an entity should be required to invoke a floor but instead should be required to determine the foreseeable future based on reasonable and supportable evidence.
- (c) No, per our answers to (a) and (b) above.
- (d) We believe the proposal in the separate comment letter response submitted by a number of banks contemplates such changes.
- (e) Due to the limited time for the comment period, we have not been able to model all portfolios. We believe the foreseeable future for many portfolios is at least twelve months, as a twelve month period is consistent with how the current incurred loss model is applied.
- (f) If comparability is the ultimate goal, we agree that a ceiling should be established. We recommend the ceiling be no greater than two years due to the limited predictability of economic information available beyond a two-year horizon.

#### Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

#### Response

We believe for many portfolios, the foreseeable future amount will exceed the time proportional amount. Therefore, the proposed approach will force entities to do an unneeded second calculation related to the time proportional amount. As discussed above, our assessment is based on limited portfolio modeling due to the limited time period allotted for analysis of the SD.

#### Question 11

The boards are seeking comment with respect to the flexibility related to discounted amounts. Specifically, on the following issues:

- (a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the proposed approach described in paragraph B8(a)? Why or why not?
- (b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

#### Response

- (a) As discussed in our comments above, we do not support the ability to choose discounted versus undiscounted cash flows as we believe this will result in a lack of comparability among financial statements.
- (b) We do not agree with the proposed flexibility in the selection of a discount rate and recommend that current accounting guidance be retained which requires discounting cash flows at an instrument's effective rate.

#### Question 12

Would you prefer the IASB's approach for open portfolios of financial assets measured at amortized cost to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the IASB's approach (ie to recognize expected credit losses over the life of the assets)? Why or why not?

## Question 13

Would you prefer the FASB's approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the FASB's approach (ie to recognize currently credit losses expected to occur in the foreseeable future)? Why or why not?

#### Response

As discussed in our general comments we support the proposal described in the separate comment letter response submitted by a number of banks.

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We appreciate the Boards' request for feedback on this matter and appreciate the opportunity to share our views with the Boards and staff. We welcome any questions or comments you may have. Please contact me with any questions about PNC's comments at 412-762-0490.

Sincerely,

John (JJ) Matthews

**Director of Accounting Policy** 

The PNC Financial Services Group, Inc.

cc: Mr. Richard Johnson

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