



Joseph M. Riccardi  
**The Prudential Insurance Company of America**  
100 Mulberry Street, Gateway 3  
Newark, NJ 07102  
973-367-1344 / phone  
joseph.riccardi@prudential.com

May 31, 2013

Ms. Leslie Seidman  
Chairman  
Financial Accounting Standards Board  
401 Merrit 7  
PO Box 5116  
Norwalk, CT 06856-5116

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

Dear Ms. Seidman:

Prudential Financial Inc. (the “Company” or “we”) appreciates the opportunity to comment on the above referenced proposed Accounting Standards Update (“ASU”). The Company is a financial services leader with approximately \$1 trillion of assets under management at March 31, 2013, and has operations in the United States, Asia, Europe and Latin America.

Our vision of a global credit loss standard remains focused on the following three important principles: 1) financial statements should be relevant to their users and enhance comparability among issuers; 2) financial results should correspond to the economics of the investments/receivables subject to the ASU; and 3) any movement to a new credit loss standard should be cost effective to operationalize, especially when weighed against the benefits to be derived by the user communities. Our comments on the proposed standard are outlined below:

### **Scope Considerations**

The Company believes that reinsurance receivables should be specifically excluded from the scope of this ASU. By design, the pricing of reinsurance agreements considers the credit risk of the counterparty. Impairment issues (if any) should be considered and addressed in the pending insurance contracts standard.

We also believe that financial assets recognized at fair value through other comprehensive income (“FV-OCI”) should not be included in the scope of the ASU. The Company believes that financial assets measured at fair value, whether through OCI or net income, already factor in expected losses since fair value incorporates credit loss expectations. Therefore, assets recognized as FV-OCI are not overstated and should not require additional allowances. The Board acknowledges this in Subtopic 805-20-30-4 relating to business combinations stating that the: “effects of uncertainty about future cash flows are included in the fair value measure.”

Additionally, existing guidance in ASC 320-10-35 (formerly FSP FAS 115-2) effectively provides for timely recognition of credit losses. We believe this guidance is well understood by users and preparers of financial statements. Furthermore, the existing model gives users of financial statements important information regarding management’s view of when a loss has been incurred, while at the same time preserving the integrity of the balance sheet. Therefore, we recommend that the Board specifically exclude FV-OCI from the scope of the ASU and retain the existing guidance in ASC 320-10-35.

We believe that there are also strong practical reasons supporting the exclusion of FV-OCI assets from the model. Under the proposed recognition and measurement guidance, we believe that most FV-OCI assets will be debt securities. Companies may not have retained long-dated historical information on credit losses for these assets, and, therefore, would need to compile the relevant data necessary to apply the proposed credit loss model. We believe that company-specific information is needed to factor in credit-risk-mitigation trading strategies in order to appropriately measure credit losses.

Obtaining and analyzing historical information for these assets may be a complicated endeavor as companies will need to consider information including (i) default rate statistics, (ii) historical losses due to changes in interest rates separate from credit losses, and (iii) historical portfolio management strategies as they relate to debt securities with expected credit losses. Lack of clarity in the guidance around determining historical credit losses likely may result in diversity in practice, hindering comparability. As stated above, we believe that debt investments classified as FV-OCI should be excluded from this ASU and existing impairment guidance retained. This recommendation will help to alleviate the concerns noted above.

### **Practical Expedient (ASC 825-15-25-2)**

The ASU (ASC 825-15-25-2) contains a practical expedient for FV-OCI assets. Under this practical expedient, companies may elect not to recognize expected credit losses for individual financial assets measured at FV-OCI when (1) fair value is greater than amortized cost, and (2) expected credit losses are insignificant.

We recommend that to the extent that it retains FV-OCI assets within the scope of the ASU, the Board expand the practical expedient so that it may be applied if either, rather than both, criteria are met. We believe that without modification, the practical expedient will result in volatility in the reserve due to changes in interest rates rather than in the riskiness of the portfolio (e.g., rising interest rates due to economic improvement may reduce fair values of financial assets below amortized cost even though the credit profile of the portfolio has improved). Additionally, entities holding highly rated financial assets where credit losses are expected to be insignificant may be precluded from using the practical expedient.

We further recommend that the Board expand the scope of this practical expedient (ASC 825-15-25-2) to include **all** overcollateralized assets regardless of whether or not they meet the definition of “collateral dependent”. As previously noted, fair value includes the probability of default; therefore, similar to assets in unrealized gain positions, overcollateralized assets should not require recognition of expected credit losses.

Finally, since it is not apparent to us why the Board only permits use of the practical expedient for FV-OCI assets, we recommend expansion of the application of the practical expedient to include all assets covered by the model (i.e., both FV-OCI and amortized cost assets).

We believe that the recommendations above will direct the focus of analysis towards assets that are more likely to experience credit losses in the future, while at the same time reducing the operational complexities and financial costs of applying the new standard.

### **Interest Income Recognition**

We have significant concerns about the income recognition guidance included in the ASU. Many insurance companies record investment income earned separately from credit losses. Investment income represents the return on the adjusted cost basis of invested assets and is generally a level yield over the life of the instrument. In contrast, credit losses arise from defaults on original investments and are perceived to be more volatile as credit markets shift or as borrowers experience financial difficulties. Investment income is an important measure as it is often matched against crediting rates on liabilities to project future income from operations. The current proposal will likely create an unwarranted significant reduction in investment income for many companies. Therefore, in order for us to provide the most meaningful financial statements, we recommend the changes noted below.

The ASU supersedes and does not appear to provide replacement guidance for Subtopic 325-40 (formerly, EITF 99-20) relating to the recognition of interest income for lower rated beneficial interests (“BIs”) in securitization transactions (i.e., the proposed guidance does not provide income recognition guidance for this class of investments). Debt securities currently have established guidance which allows the amortized cost basis (inclusive of impairments) to accrete to the best estimate of an entity’s future cash flows. The accretion approach to income recognition centers on the premise that the cost basis of a financial instrument is the present value of projected cash flows. This concept was solidified with the adoption of ASC 320-10-35 under which subsequent changes to cash flows affect the amortization pattern either retrospectively or prospectively.

We recommend that the Board retain the guidance in ASC 325-40 related to interest income recognition since we believe it is well understood and accepted by both preparers and users of financial statements. If the Board decides not to retain current guidance or, alternatively, provides new interest income recognition guidance, we request that it publicize its rationale and allow constituents the opportunity to comment.

The Company also has concerns about the proposed nonaccrual guidelines. The proposal requires investors to cease accruing interest income when it is not probable that they will receive substantially all of the principal, or substantially all of the interest. The proposal also mandates the use of the cost recovery method when it is not probable that investors will receive repayment of substantially all of the principal.

In other areas of GAAP, 10% is used to measure significance (i.e., an entity would be considered to receive substantially all of its interest or principal if were to receive at least 90% of the amount it is owed). If this threshold were applied to this situation, investors would be required to significantly delay income recognition for situations when, for example, it would be probable that they would receive 90% of principal. We believe that this is punitive and would create significant mismatches between income on investments and offsetting expenses on insurance liabilities.

As a result, we recommend that the Board remove the additional income recognition guidance related to when assets should be placed on nonaccrual status. We believe that this is a judgment that should be made by the reporting entity based on all facts and circumstances.

The Board’s proposed guidance on purchase credit impaired investments (“PCI”) also affects income recognition. Our concerns and recommendations about the income recognition guidance for PCI investments are detailed below.

### **PCI Investments**

We believe that the proposed model for purchase credit impaired (“PCI”) investments (the “PCI Model”) has several issues. For example, substantially similar securities issued by the same issuer may be subject to different impairment and interest income recognition models depending on whether they are issued prior to or subsequent to a significant change to the issuer’s credit. Under the PCI model, interest income recognized could essentially equal the risk free rate (absent a liquidity premium); while for non-PCI investments, interest income recognition would include the credit spread component (non-PCI would also be subject to a day 1 realized loss for the current expected credit loss reserve).

To further illustrate, a company can issue substantially similar securities before and after a downgrade. Under the proposed model, if both securities were purchased at the same time, the security issued prior to downgrade would presumably be considered PCI; whereas the security issued subsequent to the downgrade would not be considered PCI since it did not experience a significant deterioration in credit quality since origination. Investors could theoretically choose the accounting model they preferred for securities with similar/identical economic characteristics.

Another concern related to the PCI model is that it requires entities to gross up the basis of PCI investments for the portion of the discount related to credit. This could have the effect of producing a book yield equivalent to the risk free rate (absent a liquidity premium). We believe the spread component of the yield is an important measure and is critical to understanding whether or not our net investment income is in excess of the crediting rate of our liabilities. To not include the credit spread would impair the user’s ability to understand the profitability of our business.

The Company also has concerns that the definition of PCI assets is too broad. Under the proposal, an investment would be classified as PCI if it has experienced significant credit deterioration since origination. The Board does not define "significant deterioration" leaving it to the assessment of the investor, which may result in diversity in practice as companies may develop different views as to what constitutes "significant deterioration". For all of these reasons, we recommend that the Board retain the existing definition of PCI and the existing guidance for income recognition in ASC 310-30 (formerly SOP 03-03).

### **Transition**

If adopted as proposed, the implementation of this guidance through a cumulative effect adjustment will be complex as it relates to debt securities, particularly BIs. Our recommendation to exclude financial assets measured at FV-OCI from the scope of this ASU will provide significant relief in calculating the cumulative effect adjustment.

In determining the cumulative effect adjustment for debt securities, companies will need to reverse (i) previous impairments, (ii) subsequent income recognition and (iii) repayments of principal. They will also need to apply the new standard including the new income recognition and nonaccrual guidelines. If the Board adopts the guidance as proposed, we request that it provide relief by allowing the new income recognition guidance to be prospectively applied. This will result in a reserve established at adoption and nonaccrual status determinations made at adoption and applied prospectively.

Overall, we realize that the impact of this standard will be widespread affecting most reporting entities. The requirements to evaluate many financial instruments to determine credit losses will be, in many cases, both complex and operationally time consuming. Therefore, we request that the Board provide sufficient time for reporting entities to assess the new requirements, make operational changes and technological enhancements, and determine the reporting and disclosure impact. We recommend that the transition period be no shorter than three years and that this ASU not become effective before the recognition and measurement and insurance contracts standards as these standards are interrelated. We also believe that the Board should consider industry outreach and field testing given the many complexities associated with the proposed standard.

\*\*\*\*\*

We appreciate the opportunity to comment on this ASU. We hope you find our comments informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter, please contact me at (973) 367-1344.

Sincerely,



Joseph M. Riccardi  
Vice President - Accounting Policy