

## Investor Advisory Committee

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### Via Email

June 10, 2013

Technical Director  
Financial Accounting Standards Board  
File Reference No. 2011-230  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

**Re: File Reference No.2012-260: Proposed Accounting Standards Update—*Financial Instruments—Credit Losses (Subtopic 825-15)***

Dear Technical Director:

The Investors Advisory Committee (IAC)<sup>1</sup> welcomes the opportunity to comment on the FASB's *Financial Instruments-Credit Losses* (Subtopic 825-15) exposure draft. Our comment letter's conclusions are as follows:

First, majority of IAC prefers the FASB current expected credit losses (CECL) model which incorporates lifetime expected credit losses compared to today's US GAAP model and the IASB's proposed 3-stage model.

Second, the scope of the CECL model should only include loans and should not be applied to debt securities measured at FV-OCI.

Third, IAC supports the proposed changes to purchased credit impaired accounting because the changes will provide greater consistency with the accounting for originated loans. However,

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<sup>1</sup> This letter represents the views of the Investor Advisory Committee ("IAC" or "Committee") and does not necessarily represent the views of its individual members or the organizations by which they are employed. IAC views are developed by the members of the Committee independent of the views of the Financial Accounting Standards Board and its staff. For more information about the IAC, including a listing of the current members and the organizations in which they are employed, see <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1175801857636>.

FAS 141R appears to be in conflict with the CECL model. It appears the accounting for purchased financial assets that are not credit impaired, will differ, since expected credit loss reserves cannot be established at acquisition. Therefore, IAC recommends the elimination of the FAS 141R business combination accounting treatment that prevents the reserves of an acquired bank to be recognized in the balance sheet of the acquiring institution.

Fourth, sufficiently robust and comparable disclosures are needed to allow investors to better discern which management teams are being more or less aggressive in their assumptions and how the assumptions fare against actual experience over time.

Fifth, some IAC members and investors have concerns about the CECL model's "too much too soon" associated with Day 1 losses, the lack of a matching principle in this model and the potential for earnings management by banks. Furthermore, the accounting concept behind the lifetime expected loss model could have far reaching implications for many industries.

Sixth, the majority of IAC want a converged global impairment model.

1. Majority of IAC prefers the FASB current expected credit losses (CECL) model which incorporates lifetime expected credit losses compared to today's US GAAP model and the IASB's proposed 3-stage model.

IAC views the proposed CECL model, when implemented across loan portfolios, as superior to both current GAAP and the IASB's proposed 3-stage model. The positives of the CECL model are:

- a) The model better captures the lifetime expected credit losses of a lending transaction
- b) Is more forward-looking and could prove less pro-cyclical than either current GAAP or the IASB's proposed 3-stage model.
- c) May be less complex than the IASB's 3-stage model. The IASB's recognition trigger when assets move from Stage 1 to either Stage 2 or 3 due to a significant deterioration in credit quality may potentially add too much complexity and non-comparability to this model.
- d) Has a more accurate lifetime expected loan loss allowance on the balance sheet when properly implemented. The latter, as always, is subject to management discretion but this is the always the case when management estimates are used in accounting standards.

Some in the banking industry may legitimately complain the model will result in more credit expense recognition earlier in the lending cycle than the IASB proposal or current accounting and does not as closely match the credit expense with the associated revenues. However, IAC believes it better reflects the economics in lending. Losses can occur at any point once a loan has been originated or committed to and they don't tend to evenly match the associated

revenues over the life of a loan. Therefore, it is better to reflect the expected loss on the balance sheet and recognize it in the income stream immediately. IAC understands lenders don't expect losses on individual loans, otherwise they wouldn't originate them. That said, lenders do have a general idea of what losses will eventually emerge from a portfolio of loans over time and in different economic /cyclical scenarios, so there is no reason a lender should delay the recognition of an expected loss until the individual loans actually default.

Notably, a lender with a seasoned portfolio (including loans across various points of their maturity schedule) growing at a moderate rate will probably not be heavily impacted by the implementation of the CECL model on an ongoing annual basis. However, the initial one-time increase in the allowance for loan losses to comply with CECL is estimated, by independent sources, to have a potential significant impact on both reported earnings and stockholders' equity.

IAC believes it is appropriate accounting for a rapid growth lender to recognize noticeably higher loan loss provisions early on in the loan life cycle, particularly for a lender that does not have a large existing portfolio at various stages of maturity. Credit has historically proven most risky following periods of rapid growth, both at an industry level and at individual lenders as underwriting operations and standards tend to weaken due to competitive pressures. Loan loss provisions that reflect these risks sooner in a rapid growth business model or industry-wide rapid growth cycle seem both logical and desirable.

IAC prefers the CECL model to the proposed IASB 3-stage model because it results in a more accurate valuation of loans on the balance sheet. In addition, with sufficiently robust disclosure, changes in reserves in the CECL model from period to period should be easier to decompose into changes in volume across different loan types (mix), changes in portfolio age (seasoning/maturity) and changes in management's assumptions about losses inherent in the different portfolios (model errors, positive or negative in original loss expectations and/or the current credit/economic credit cycle assumptions more broadly). IAC believes this kind of decomposition should give investors strong indications of management's ability to assess and price for credit risk over time and through cycles.

The IASB 3-stage model's recognition trigger when a significant deterioration in credit quality occurs, in contrast, creates added complexity when assets move from Stage 1 to either Stage 2 or 3. This will likely increase reserve requirements early in an economic downturn creating the cliff effect that has been criticized as too pro-cyclical compared to the CECL model that more correctly assesses the full risk at the outset of a lending relationship. In addition, a 3-stage model will create unnecessary complexity for investors in assessing whether managements risk assumptions and models are reasonable. Are the higher reserves/higher credit costs reflecting a normal progression in an economic cycle (e.g. just higher delinquencies) or are they reflecting performance that is worse than management's expectations when the loan was originated?

2. The scope of the CECL model should only include loans and should not be applied to debt securities measured at FV-OCI.

IAC believes debt securities should not be included in the scope of this accounting standard. Our view is based upon the fact that most debt securities have readily available market values. These market values inherently incorporate both the interest rate and loss expectations of investors. IAC does not believe booking impairments against debt securities will provide investors with decision useful information.

IAC wants all debt securities measured at fair value on the balance sheet. It is our understanding that under the new classification and measurement proposal some debt securities that are currently measured at FV-OCI may potentially be measured at amortized cost in the future. If debt securities with a fair value market price are measured at amortized cost IAC wants the fair value information for the debt securities disclosed on the balance sheet.

3. IAC supports the proposed changes to purchased credit impaired accounting because the changes will provide greater consistency with the accounting for originated loans. However, FAS 141R appears to be in conflict with the CECL model. It appears the accounting for purchased financial assets that are not credit impaired, will differ, since expected credit loss reserves cannot be established at acquisition. Therefore, IAC recommends the elimination of the FAS 141R business combination accounting treatment that prevents the reserves of an acquired bank to be recognized in the balance sheet of the acquiring institution.

One aspect of CECL that is unanimously supported is it would eliminate the prospective treatment of the non-accretable yield adjustment in SOP 03-3. IAC's opinion is the current treatment under SOP 03-3 is confusing to investors. In addition, many investors exclude the accretable yield amortization from their income statement models.

Finally, one aspect that appears to be in conflict with CECL is FAS 141R, *Business Combinations*. Based upon numerous well-documented estimates, CECL is projected to have a material, negative up-front impact on the banking industry in regards to both net income and shareholders equity due to the projected increase in loan loss reserves. However, as is well documented, FAS 141R eliminates loan loss reserves of the institution being acquired in a simple merger or acquisition. In our view, any potential change to the impairment model needs to fully incorporate the elimination of FAS 141R, IAC would prefer the impairment accounting for originated and acquired loans to be consistently applied. This position is heightened in a consolidating industry, with banking experts from nearly every profession predicting will occur.

4. Sufficiently robust and comparable disclosures are needed to allow investors to better discern which management teams are being more or less aggressive in their assumptions and how the assumptions fare against actual experience over time.

Currently loan loss reserve disclosures are limited and non-comparable across banks. In addition, SOP 03-3 and FAS 141R further confuse and complicate analysis of reserve adequacy. The proposal takes major steps to address these issues and we want to commend FASB on this progress on disclosures. We believe the elimination of FAS 141R along with SOP 03-3 is important in this regard.

IAC believes the roll forward analysis of the loan loss reserve by loan type and by vintage, when relevant, is critical for investors to understand managements' approach to reserving and to compare reserves across firms. In this regard we recommend enhanced examples in the proposal of reserve roll forward analysis by portfolio and examples of appropriate portfolio segment breakdowns.

5. Some IAC members and investors have concerns about the CECL model's "too much too soon" associated with Day 1 losses, the lack of a matching principle in this model and the potential for earnings management by banks. Furthermore, the accounting concept behind the lifetime expected loss model could have far reaching implications for many industries.

The "too much too soon" associated with Day 1 losses and the lack of a matching principle in this model is in reality the same issue. IAC recognizes these are legitimate issues especially since the CECL model's loan loss provision accounting will be very different than current US GAAP accounting.

Once loan loss provision accounting transitions to an expected loss model which is supported by IAC the primary issue is what time period should you look forward to determine the amount of loan loss provisions? In the FASB proposal a financial institution would book full lifetime reserves on Day 1, while the IASB's model would only book 12-month reserves based on the PD\*LGD formula until there is a significant deterioration in credit quality and then the accounting is similar to the FASB proposal.

Some investors have expressed concerns that the FASB model is a principles based accounting model that will provide bank managements wide latitude in determining loan loss provisions. Impairments are booked based on the "the current estimate of contractual cash flows not expected to be collected on financial assets" using historical loss information, current conditions, and future economic forecasts.

IAC agrees the CECL model will provide managements more latitude than current accounting, however, we offer the following observations. First, the current incurred loss model provides bank managements flexibility when booking impairments and many accounting experts note that most US banks already look forward 1-2 years when booking impairments, so a 12-month approach might actually reduce loan loss allowances. Second, the CECL model eliminates the probable threshold trigger which a majority of IAC supports. In contrast, the IASB proposal

includes the significant deterioration in credit quality recognition trigger which IAC believes is overly complex and is likely to be applied inconsistently across banks.

IAC is also sympathetic to investor concerns that any expected loss model could lead to earnings management including the smoothing of earnings. However, IAC believes banks have historically utilized current accounting rules to manage and smooth earnings. Therefore, IAC has discussed in a prior section that enhanced disclosures are necessary to limit, not eliminate which is impossible, the management and smoothing of earnings.

6. The majority of IAC want a converged global impairment model.

IAC prefers the FASB's full lifetime expected loss model over the IASB's 12-month expected loss model. However, if a reasonable compromise can be reached IAC would prefer a converged solution. Having two different impairment models will be detrimental to the needs of US and global investors. Two different standards that result in material non-comparability between banks, and don't provide footnote disclosures for analysts to bridge the non-comparability gap, would be a suboptimal outcome from this project. As one bank analyst who covers international banks at one of our firms noted "I support an expected credit loss model, however, it's debatable whether a 12-month time horizon or lifetime horizon is the best solution."

IAC is opposed to the compromise proposed by the US Banking industry in their May 10, 2013 FASB comment letter. This comment letter proposes to measure impairments as follows: "Rather than measuring expected losses over the next 12 months or over the remaining contractual life, we recommend that the Boards amend the expected loss measurement period to the greater of 12 months or the period that is reliably estimable and predictable." This accounting approach which allows management to determine what time period to consider when measuring impairments could in our opinion lead to loan loss provision accounting that is non-comparable between banks to the detriment of analysts.

## Responses to Questions Raised in Exposure Draft

**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?*

The scope of the CECL model should only include loans and should not be applied to debt securities measured at FV-OCI. IAC believes that debt securities should not be included in the scope of this accounting standard. Our view is based upon the fact that most debt securities have readily available market values. These market values inherently incorporate both the interest rate and loss expectations of investors. IAC does not believe booking impairments against debt securities will provide investors with decision useful information.

**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?*

IAC supports the elimination of the probable threshold accounting under the current US GAAP incurred loss model.

**Question 3:** *As a result of the proposed amendments, the net amortized cost on the balance sheet (that is, net of the allowance for expected credit losses) would reflect the present value of future cash flows expected to be collected, discounted at the effective interest rate. Do you agree that the net amortized cost (which reflects the present value of cash flows expected to be collected) results in more decision-useful information than currently exists under U.S. GAAP?*

IAC prefers the CECL model to the proposed IASB 3-stage model because it results in a more accurate valuation of loans on the balance sheet. In addition, with sufficiently robust disclosure, changes in reserves in the CECL model from period to period should be easier to decompose into changes in volume across different loan types (mix), changes in portfolio age (seasoning/maturity) and changes in management's assumptions about losses inherent in the different portfolios (model errors, positive or negative in original loss expectations and/or the current credit/economic credit cycle assumptions more broadly). IAC believes this kind of decomposition should give investors strong indications of management's ability to assess and price for credit risk over time and through cycles.

**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)?*

Some in the banking industry may legitimately complain the model will result in more credit expense recognition earlier in the lending cycle than the IASB proposal or current accounting and does not as closely match the credit expense with the associated revenues. However, IAC believes it better reflects the economics in lending. Losses can occur at any point once a loan has been originated or committed to and they don't tend to evenly match the associated revenues over the life of a loan. Therefore, it is better to reflect the expected loss on the balance sheet and recognize it in the income stream immediately. IAC understands lenders don't expect losses on individual loans, otherwise they wouldn't originate them. That said, lenders do have a general idea of what losses will eventually emerge from a portfolio of loans over time and in different economic /cyclical scenarios, so there is no reason a lender should delay the recognition of an expected loss until the individual loans actually default.

Notably, a lender with a seasoned portfolio (including loans across various points of their maturity schedule) growing at a moderate rate will probably not be heavily impacted by the implementation of the CECL model on an ongoing annual basis. However, the initial one-time increase in the allowance for loan losses to comply with CECL is estimated, by independent sources, to have a potential significant impact on both reported earnings and stockholders' equity.

IAC believes it is appropriate accounting for a rapid growth lender to recognize noticeably higher loan loss provisions early on in the loan life cycle, particularly for a lender that does not have a large existing portfolio at various stages of maturity. Credit has historically proven most risky following periods of rapid growth, both at an industry level and at individual lenders as underwriting operations and standards tend to weaken due to competitive pressures. Loan loss provisions that reflect these risks sooner in a rapid growth business model or industry-wide rapid growth cycle seem both logical and desirable.

**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 collectibility of the financial assets' remaining contractual cash flows. Do you believe that expected credit losses based on this information provide decision-useful information?*

Yes, IAC supports the expected credit losses definition and believes it will provide investors with decision-useful information.

**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?*

IAC supports the proposed changes to purchased credit impaired accounting because the changes will provide greater consistency with the accounting for originated loans. However, FAS 141R appears to be in conflict with the CECL model. It appears the accounting for purchased financial assets that are not credit impaired, will differ, since expected credit loss reserves cannot be established at acquisition. Therefore, IAC recommends the elimination of the FAS 141R business combination accounting treatment that prevents the reserves of an acquired bank to be recognized in the balance sheet of the acquiring institution.

**Question 16:** *Under existing U.S. GAAP, the accounting by a creditor for a modification to an existing debt instrument depends on whether the modification qualifies as a troubled debt restructuring. As described in paragraphs BC45–BC47 of the basis for conclusions, the Board continues to believe that the economic concession granted by a creditor in a troubled debt restructuring reflects the creditor's effort to maximize its recovery of the original contractual cash flows in a debt instrument. As a result, unlike certain other modifications that do not qualify as troubled debt restructurings, the Board views the modified debt instrument that follows a troubled debt restructuring as a continuation of the original debt instrument. Do you believe that the distinction between troubled debt restructurings and nontroubled debt restructurings continues to be relevant? Why or why not?*

The majority of IAC members support the elimination of troubled debt restructuring accounting because it does not provide investors with decision useful information. Other IAC members believe that TDR disclosures should be retained but would want better disclosure about the history of performing and non-performing TDRs.

**Question 17:** *Do you believe the disclosure proposals in this proposed Update would provide decision-useful information? If not, what disclosures do you believe should (or should not) be required and why?*

Sufficiently robust and comparable disclosures are needed to allow investors to better discern which management teams are being more or less aggressive in their assumptions and how the assumptions fare against actual experience over time.

Currently loan loss reserve disclosures are limited and are non-comparable across banks. In addition, SOP 03-3 and FAS 141R further confuse and complicate analysis of reserve adequacy. The proposal takes major steps to address these issues and we want to commend FASB on this progress on disclosures. We believe the elimination of FAS 141R along with SOP 03-3 is important in this regard.

IAC believes the roll forward analysis of the loan loss reserve by loan type and by vintage, when relevant, is critical for investors to understand managements' approach to reserving and to compare reserves across firms. In this regard we recommend enhanced examples in the proposal of reserve roll forward analysis by portfolio and examples of appropriate portfolio segment breakdowns.

**Question 21:** *Do you agree that early adoption should not be permitted? If not, why?*

Early adoption should not be permitted given the magnitude of the changes to impairment accounting. Permitting early adoption by some financial institutions would not serve the needs of investors.

Sincerely,

*Investor Advisory Committee*

**Investor Advisory Committee**