

## Investor Advisory Committee

401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | Phone: 203 956-5207 Fax: 203 849-9714

### Via Email

April 16, 2015

Technical Director  
Financial Accounting Standards Board  
File Reference No. 2012-260  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

### **Re: Financial Instruments – Credit Losses**

Dear Technical Director:

The Investor Advisory Committee (IAC)<sup>1</sup> issued a comment letter on the FASB’s Financial Instruments-Credit Losses exposure draft (“CECL”) on June 10, 2013. IAC members and the FASB have held numerous meetings and conference calls since the initial letter.

This comment letter updates conclusions provided in the previous letter based upon the following:

1. Membership of IAC has changed primarily due to the four year term of an appointment.
2. The FASB has provided additional information since the June 10, 2013 letter which has resulted in some IAC members having continued or increased concerns about the determination of the credit loss accrual and related aspects of CECL.

---

<sup>1</sup> This letter represents the views of the Investor Advisory Committee (“IAC” or “Committee,” previously called ITAC) 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>.

April 16, 2015  
Page 2

3. Significant events related to commodity, currency and interest rate risk have occurred which raise questions about management teams' ability to accurately forecast lifetime expected losses on Day 1 for loans. Market risks ultimately help inform management teams' forecasts of expected credit losses and can have a significant impact on loss accruals.
4. The IASB has finalized a new loss reserve model which incorporates both a bright line current loss provision and a lifetime loss provision under specific circumstances. This standard is effective for IFRS filers starting January 1, 2018.

Currently, IAC members have wide ranging views on the proposed CECL model. However, a majority view the proposed model as needing improvements on topics listed in the body of this letter under "Points of General Concern." These points address process/implementation, lifetime losses accrued on Day 1, and IFRS convergence. The IAC welcomes further discussion with the Board and staff, if so requested.

### **Points of General Concern of IAC**

#### **Process for Assessing the Impact of Implementation of New Standards –**

IAC members collectively support a dialogue with the FASB prior to official drafting that result in more effective information being provided to the Committee as it relates to CECL. The IAC would like to have a better understanding of how the FASB intends for the model to work upon implementation regardless of IAC members' opinions on the CECL concept itself. Specifically, meetings with FASB related to purchase accounting over several months raised significant concerns (discussed further below) which require further discussion over how the model may be implemented. It is the IAC's expectation that continued constructive dialogue on implementation matters can alleviate concerns and could lead to a result that would be in the best interest of investors and users of financial statements.

#### **Lifetime Losses Accrued on Day 1 –**

IAC members encourage the FASB to provide additional information as to how CECL establishes reasonable and supportable assumptions used to model out lifetime losses on Day 1 for loans and debt instruments. Opinions and support for CECL as a principle vary significantly among members. Increased disclosure and discussion may help to bridge differing opinions among IAC members.

April 16, 2015  
Page 3

***Dissenting Opinions Related to CECL and Lifetime Day 1 Losses for Loans and Debt Instruments***

Among some IAC members, the accuracy and rationale of accruing lifetime losses on Day 1 is of significant concern. In addition, if the lifetime loss is recorded “upfront,” a mismatch is created between revenue and expense recognition. The key assumption with CECL is largely dependent on management’s assessment of the collectability of loans (and other in-scope financial assets) looking out over their expected lifetime. Market participants, management teams, regulators, third-party valuation firms and auditors will need to raise questions about the appropriate assumptions used to determine the amount of the loan provision. Greater potential for error exist the longer the loan duration. The accrual will also be based in part on the direction of the economic cycle. In addition to credit risk, loans may also be subject to market risks such as interest rate, commodity or currency risk which can ultimately impact credit risk. Considering these risks, investors have, consequently, raised concerns about management’s latitude for determining reasonable and supportable assumptions used to model out these loans.

Certain members of IAC also raise concern CECL will result in large loss reserves with inadequate consideration of the true risk involving specific loans or debt instruments. In addition, volatility and events not captured in companies’ internal risk models will not be accrued for properly. Implementation within companies as it relates to internal data compiled by management may be at odds with what investors see, read and analyze as part of their own research. Thus, loss provisions and reserve balances disclosed under CECL would not be considered any more reliable than current accrual and reserves balances under current GAAP, which we encourage to be modified.

Management’s assumptions are the most important factor for determining reserves and for investors to assess. No accrual under any methodology will capture losses with exact precision. However, attempting to project losses beyond a reasonable time period and immediately recognizing the full expense may not properly reflect the economics of lending while using financial assumptions which could contain biases. Comparability across companies within an industry will be made more difficult due to varying assumptions.

Subsequent to the June 10, 2013 letter, there have been several significant events that caught many forecasters by surprise. The Swiss central bank decided to no longer support its peg to the Euro, the Russian ruble declined in value relative to other currencies, and oil prices declined by 50%. Exposure to interest rate and commodity risks should result in a reassessment of losses on those loans subject to these risks once the unexpected event occurs. Loans, issued in Euros, to Russian companies and loans issued to high production cost U.S. oil shale companies may now be faced with significantly higher risks of default. Due to these unexpected events that have occurred since our June 2013

April 16, 2015  
Page 4

letter, it appears managements' ability to precisely or accurately forecast loan losses in a two year period is limited, let alone over the full lifetime of a loan. In other words, market risks can ultimately impact credit risk and the ability for management teams to accurately forecast loss accruals raises concern.

***Favorable Opinions Related to CECL and Lifetime Day 1 Losses for Loans and Debt Instruments***

Some members in IAC are in favor of accruing lifetime losses on Day 1, recognizing there may be significant hurdles to other alternatives. Under CECL, the balance sheet would reflect the current estimate of lifetime expected credit losses at the reporting date, and the income statement would reflect the effects of credit trends (improvement or deterioration) during the reporting period. Credit losses are an expected part of lending and fixed-income investing, and management teams incorporate expected future losses when they price loans. These members believe CECL will lead to more timely recognition of credit losses and that estimation reliability concerns should not stand in the way of the above benefit. Consistent with the view articulated by the IAC in its June 10, 2013 letter, certain IAC members believe that the CECL model better captures credit losses in lending portfolios and is more forward-looking and could prove less pro-cyclical than either current GAAP or the IASB's 3-stage model. The FASB has also stated in its proposal that a long-term average loss rates can be used for more distant time periods beyond the period for which specific events can be projected.

Members supporting CECL believe a forward-looking single measurement approach, coupled with comprehensive quantitative and qualitative disclosures, will better help analysts evaluate the adequacy of a company's credit loss reserves and provide greater insight into management's credit loss expectations that reside within its existing financial asset portfolio.

Some IAC members prefer the CECL model to the proposed IASB 3-stage model because it results in a more accurate valuation of loans and fixed income securities on the balance sheet. Further, it is less complex and is not reliant on a trigger event for recognition of all expected losses.

Certain members believe estimation reliability concerns should not stand in the way of improved accounting and financial reporting. Companies should reflect expected credit losses in a timely manner. To the extent management has concerns over the reliability and predictability of forecasted information, those members supporting CECL prefer that companies derive their most informed estimate and disclose the amounts and basis for those estimates (this may include reverting to plausible historical trends for longer-term horizons).

April 16, 2015  
Page 5

While understanding that market fluctuations (such as those pertaining to sudden currency and oil prices mentioned earlier in this letter) will occur and may not always be predictable, CECL requires re-estimation each reporting period resulting in the inclusion of credit risk and market-related data in loss estimates on a more timely basis than under current GAAP or the IASB 3-stage model. Some IAC members further believe the macroeconomic factors that influence the underwriting and credit analysis on potential new financing should be reflected in current loan loss reserving or impairment of outstanding debt or loans, rather than waiting for a triggering event such as a default to occur. These members believe that incorporating reasonable and supportable market-driven forecasts in estimated credit losses under CECL will be more meaningful to investors than under current GAAP.

### **Convergence with IFRS -**

IAC members are in favor of convergence with IFRS standards if those standards are reasonable. Subsequent to June 10, 2013, the IASB in July of 2014 published a final version of IFRS 9, Financial Instruments. Expected credit losses, under IFRS 9, are to be measured at an amount equal to (1) the 12-month expected credit losses resulting from default events on the financial instruments possible with 12 months of the reporting date, or (2) full lifetime expected credit losses resulting from default events over the life of the financial instrument. A full lifetime loss is expected if the credit risk of an instrument has increased significantly since initial recognition.

Some members of IAC do not agree with a 12 month time horizon as finalized by IFRS and feel CECL can be amended to allow for low risk credit instruments to have loss accruals for a period deemed reasonable which in many circumstances could be in excess of 12 months but not subject to lifetime Day 1 losses. Many financial institutions have historically maintained loss reserves at re-measurement periods exceeding the following year's net charge-offs by an additional 12 months. A reserve in excess of 12 months of charge-offs may be considered more conservative than what current GAAP or recent IFRS rules have intended as a result of regulatory influence.

As a result, some IAC members inquire whether lifetime Day 1 losses need not be recognized on "low risk" loans. This would be similar to the IFRS standard recently issued. "High risk" loans could be subject to CECL and accrue lifetime Day 1 losses. Determining a trigger event for what constitutes a high risk is subjective. However, specific business conditions which can constitute high risk lending and debt instrument possession is often thoroughly understood by investors and users of financial statements even if the ultimate trigger event generating significant losses is not yet apparent.

Regardless of differing opinions related to applying CECL, the IAC acknowledges that estimates of lifetime Day 1 losses are currently applied in GAAP for other industries. For example, the

April 16, 2015  
Page 6

accrual for warranties is an estimate of the lifetime cost expected over the duration of the warranty recognized at the time of sale. Companies are required to make adjustments to their warranty accruals which on occasion may be material to financial results. Current and prior period adjustments will often be disclosed separately in the roll forward of the warranty reserve provided in the notes of the financial statements. The matching principle is applied in this case as the expected warranty cost is booked at the time of sale. However, some IAC members comment that CECL and the application of lifetime loan losses accrued on Day 1 moves away from the matching principle as revenue related to lending activity is accrued over the duration of the loan. For example, under FAS 91, loan origination revenues and specifically identified related expenses are both deferred and recognized over the life of the loan.

The implementation of CECL, independent of support or lack thereof, may result in both direct and related costs. The largest accrual impact to banking institutions would be the expected increase in loan loss reserves. Direct costs would include expenses incurred by management to establish new internal controls and procedures to appropriately account for these accruals.

Concerns are likely to be raised about consistent implementation across firms which impact analyses by investors and financial statement users. A significant related cost to equity holders of financial institutions may result when regulators see reductions in capital and restrict a company's ability to allocate capital between organic growth, acquisitions, or returning excess cash to shareholders.

### **Points of General Support of IAC**

#### **Acquisition Accounting -**

Acquisition accounting issues raised in the June 10, 2013 letter strongly advised the FASB to address concerns with the FAS 141(R) business combination accounting treatment of loans and reserves. Under current GAAP, accounting reserves of an acquired bank cannot be recognized in the balance sheet of the acquiring institution. Because reserves of the acquired institution are eliminated in acquisition accounting, comparability among institutions has been materially distorted. Loans of the acquired business are instead brought on the acquired company's balance sheet at fair value without an option to retain the loan at book value on the acquirer's balance sheet. Nor can the acquirer accurately reflect what management thinks is the true value of the loss reserve.

Subsequent to the June 10, 2013 letter, the FASB has proposed differing accounting treatment for acquired loans with low risk of impairment compared to those with high risk of impairment. IAC members raised concerns that the guidelines provided would result in acquired loans with low risk being subject to loan provisions being taken twice. Loans acquired with high risk of impairment, however, would be reported at fair value with no additional loss provisions taken.

April 16, 2015  
Page 7

Some IAC members propose under business combinations that an acquirer be permitted to bring loans on its balance sheet at a fair value which could be current book value, in addition to allowing reserves to be brought on at fair value which could equal the acquired company's book value. The book value option would eliminate the possibility of the acquiring company having to report bad debt provisions on losses a second time after the acquisition is completed. In addition, the elimination of additional non-cash yield accretion created by fair value treatment would lead to less distortion of net interest margin.

Other IAC members support, as noted in our comment letter of June 10, 2013, proposed changes to purchased credit impaired accounting because the changes will provide greater transparency and consistency with the accounting for originated loans. However, the demarcation line between what is "credit impaired" and not "credit impaired" is very important as purchased debt instruments that are not credit impaired may also require an allowance in addition to any credit losses already incorporated into the fair value. Therefore, those IAC members would encourage the FASB to consider changing the current definition of credit impaired to include any purchased debt instrument for which a credit loss is measurable in the fair value on the purchase date.

#### **Disclosures –**

IAC unanimously supports having additional disclosure to accompany changes to credit impairment accounting. Regardless of the shape of the financial standard, the quality and quantity of disclosures is paramount to investors' ability to evaluate management's decision making and develop informed opinions. Poor disclosure was one cause of the financial crisis.

Subsequent to June 10, 2013, IAC members were presented by the FASB with proposals for vintage disclosures. IAC members as a group are in support of vintage disclosures which provide credit quality by both years of origination and risk rating for each asset class level. This disclosure should include reserve data by vintage and class which reconciles to the total allowance for loan losses. Companies should also be required to provide information within the financial statement footnotes explaining changes to the allowance by vintage and class, detailing the specific type of lending impacted and the potential for future changes to current reserve levels. IAC members also learned that a financial institution can eliminate vintage disclosure if they use Fair Value. The majority of the Committee feels vintage disclosure should be required for all institutions, even if using Fair Value.

In addition, FASB presented IAC with proposed disclosure related to loan roll-forwards for loans at amortized costs. Disclosure for allowance for loan losses is not part of the current proposal. IAC members are in favor of disclosure breaking out the provision of credit losses into its components to better assess the composition between estimate revisions, originations and purchases despite pushback from other constituents about the difficulty in providing that information with each SEC filing of financial results.

April 16, 2015  
Page 8

Clear and understandable insight into how management derives its loss estimate is key to investors. IAC acknowledges that comparisons across companies may be difficult as institutions may not be consistent in the classification of assets. The ability of investors to access credit quality across asset classes, however, will be enhanced.

This comment letter represents the views of IAC members and information available at this time. Changes in membership of the Committee may also cause the opinions of the Committee to change. Changes to the proposed standard or occurrence of other significant events may cause the opinion of the Committee to change. The IAC stands ready to work with and assist the FASB staff regarding this topic.

Sincerely,

*Investor Advisory Committee*

**Investor Advisory Committee**