



International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

Technical Director, File Ref 2011-150  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk  
CT 06856-5116

Grant Thornton International Ltd  
Grant Thornton House  
22 Melton Street  
London  
NW1 EP

Grant Thornton LLP  
175 W Jackson  
20th Floor  
Chicago  
IL 60604

1 April 2011

Submitted electronically to [director@fasb.org](mailto:director@fasb.org)

**Re: Supplementary Document: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment**

Grant Thornton International Ltd and its U.S. member firm, Grant Thornton LLP, appreciate the opportunity to jointly comment on the International Accounting Standards Board's (IASB) and the Financial Accounting Standards Board's (FASB) Supplementary Document, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment*.

Below we have provided general comments on the Supplementary Document. Our responses to specific questions raised in the "Joint Invitation to Comment" section of the Supplementary Document are included in Appendix A, and our responses to specific questions raised in the "IASB-Only Appendix Z Presentation and Disclosure" section of the Supplementary Document are included in Appendix B.

#### General comments

##### Lack of cohesive concept and principle

We do not believe that the proposed approach in the Supplementary Document is a cohesive and principles-based solution to finding a compromise between the Boards' earlier proposals. We believe that a robust standard should include a clear description of what it is that the allowance for loan losses represents or measures. For example, should an allowance for loan losses include an estimate of all expected future losses that may occur, losses expected to occur in the foreseeable future, or some other measure? As it stands, we do not believe that the Boards have articulated a consistent conceptual basis for when to recognize impairment losses. Without a consistent conceptual basis, the accounting model is purely a practical response to critics of the current model.

While we believe that the joint proposed approach goes a long way in reconciling the Boards' different objectives, it will likely not achieve the concern expressed by some constituents that, under today's GAAP, a loss is not recognized until it occurs instead of being recognized when it becomes likely that a loss will occur in the future. We believe that the Boards must establish a sound principle as to what the allowance for loan losses should represent or measure in order to address those concerns.

Additionally, we do not believe the allowance for loan losses should be used as a holder of regulatory capital. We believe prudential regulators should separately address regulatory capital requirements when considering their response to this new accounting standard. Please refer to our previous comment letter to US Prudential Regulators on this topic, included as Appendix C, and refer particularly to the section on "Dynamic Regulatory Capital Provisioning" beginning on page 3.

#### Interest income

We believe that the accounting for interest income recognition and credit loss recognition is inextricably linked, because expected cash flows include estimates of both interest income and expected credit losses. Therefore a comprehensive model is needed that addresses both interest income recognition and credit loss recognition.

#### Convergence

We believe that it is imperative that the FASB and IASB projects to improve the accounting for financial instruments arrive at a converged standard. The Boards' ultimate goal of a single set of high quality, globally accepted accounting standards should take precedence over issuing standards according to deadlines.

#### Due process

Based on our review of the Supplementary Document, we are concerned that the Boards are not far enough along in their development of a revised impairment model to meet the June 30, 2011 "deadline." We believe that there is a strong potential that the final model could be significantly different than the model proposed by both Boards and will require re-exposure. Due to the significance of impairment assessment to entities, particularly financial institutions, it is imperative that changes to the current model be carefully considered with full attention to due process. The Supplementary Document provides a limited framework for measuring impairment for a subset of financial assets and therefore does not permit us to understand how the impairment model might apply in a broader context. For example, the Supplementary Document does not address impairment for individual debt instruments, aggregation of financial assets in recognition and measurement of impairment, impairment for acquired loans with evidence of credit deterioration since origination, interest income recognition, or disclosures.

\*\*\*\*\*

If you have any questions on our response, or wish us to amplify our comments, please contact Executive Director of International Financial Reporting Andrew Watchman ([andrew.watchman@uk.gt.com](mailto:andrew.watchman@uk.gt.com) or + 44 207 391 9510) on behalf of Grant Thornton International Ltd or Mark Scoles, Partner ([Mark.Scoles@us.gt.com](mailto:Mark.Scoles@us.gt.com) or + 1 312 602 8780), on behalf of Grant Thornton LLP.

Sincerely,



Kenneth C. Sharp  
Global Leader - Assurance Services  
On behalf of Grant Thornton International Ltd



Karin A. French  
Managing Partner of Professional Standards  
On behalf of Grant Thornton LLP

## Responses to Joint Invitation to Comment Questions

**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?**

It is unclear whether the proposed approach for recognition of impairment described in the Supplementary Document deals with the concern of delayed recognition of expected credit losses, or even whether it should. We believe the proposed approach has the potential to address this concern; however, we do not believe the Supplementary Document sufficiently explains the proposed approach or how it is intended to address that issue. For example, if the “good book” impairment is measured similarly to today’s “FAS 5” approach or “IAS 39” approach for groups of financial assets collectively assessed for impairment, but modified to include consideration of reasonable future expectations, would recognizing such loss estimates over time result in even further delayed recognition? Would those loss estimates result in recognition of allowances that are lower than the losses determined under an incurred loss model?

Additionally, as discussed in our responses to other questions, we believe that the lack of clarity around the proposed approach to impairment could potentially exacerbate the current perceived weakness. For example, does the proposed model create an expectation that financial institutions will never have large, existence-threatening losses during economic slowdowns because the capital needed to weather such economic conditions is already included in the financial statements as an “allowance for loan loss”?

**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?**

**Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.**

As discussed elsewhere (for example, see our response to Question 6), we believe the proposed approach in the Supplementary Document lacks clarity that is necessary to provide appropriate feedback on how this model would work. This lack of clarity also impacts our

ability to comment on how the model would apply to closed portfolios and other instruments that would be subject to the proposed model. Additionally, it is not yet clear exactly which financial assets would be subject to the impairment model under the FASB's classification and measurement phase of the larger financial instruments project. However, based on the proposed approach, we have the following questions/concerns:

- For acquired loans with evidence of credit deterioration since origination, would those loans be classified in the “good book” or “bad book”? If in the bad book, could those loans ever move to the good book? If in the good book, would entities be prohibited from recognizing the expected cash flows and accretable yield over time—even though the entity would need a reasonable estimate of the expected cash flows in order to apply the initial recognition and measurement guidance required by other GAAP at acquisition?
- How would this model work for an investor that continues to receive regular payments from a security that will not have sufficient cash flows or has been subject to a significant credit downgrade? Would the security continue to be classified in the “good book,” even though some may argue that a loss has been incurred? Further, would losses recognized in earnings be limited only to credit losses for investment securities or would the loss also include losses due to other factors?
- For loans and investment securities, at what point should the impairment be based on an expected sale of those financial assets? For example, if an entity has a mortgage-backed security, “good book” accounting could make sense, even though not all the underlying loans are performing. However, once that security is no longer making expected payments or if the security has been downgraded, an entity's objective may change so that the source of repayment becomes sale of the mortgage-backed security. In other words, should the business strategy aspect of classification and measurement model be part of the impairment model?
- How would the model work for debt instruments that provide for deferral of some or all interest payments or for reverse mortgage loans or other assets in which regular payments are not made?

Overall, we believe that a single impairment approach for all financial assets would reduce complexity; however, based on the current status of the Boards' projects, we question whether that goal is achievable within the proposed timeline. Additionally, we believe that not all financial assets may fit clearly into the “good book” / “bad book” approach to impairment (refer to our response to Question 3). Accordingly, we believe that the Boards must provide further explanation as to whether or how the proposed model is an improvement over current GAAP.

**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?**

We believe that it is appropriate to recognize the impairment allowance for financial assets in the “good book” using a time-proportional approach. We believe that the good book approach will likely require the consideration of many of the various factors entities currently incorporate into the allowance for groups of financial assets collectively assessed for impairment under either ASC 450, *Contingencies*, or IAS 39, *Financial Instruments: Recognition and Measurement*, such as charge-off history, changes in underwriting criteria, loan-to-values, micro and macro economic factors, and changes in housing prices.

However, we believe that it is difficult to fully consider impairment recognition approaches in the “good book” in isolation, without also considering the measurement aspect of the impairment model and the recognition and measurement of interest income, because those concepts are inextricably linked.

In addition, we recommend that the Boards focus on identifying when loans should be included in the “bad book” and on ensuring that there is directional consistency with the credit quality of the “good book” and recognition of changes in the allowance for loan losses. We believe that this could be accomplished by continuing to enhance disclosure about credit quality, including disclosure of how changes factor into the allowance estimate.

**Question 4: Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?**

We believe that there would be significant operational issues. Please see our response to Question 3.

Further, we believe the Boards should consider the experience with closed pools of loans accounted for under ASC 310-30, *Receivables: Loans and Debt Securities Acquired with Deteriorated Credit Quality*, and the predecessor literature. The focus of that accounting is on the cash flows expected to be collected over the life of the closed pool, not on the accumulation of an allowance for contractual cash flows not expected to be collected. The yield recognized under ASC 310-30 is not a hypothetical revenue stream reduced by a provision for losses, but a reflection of the expected economic rate of return on the closed pool. Even so, the application of this model is not without difficulties. Nevertheless, it suggests that to the extent the Boards wish to create a new loan accounting model that recognizes the accretion of value (interest income) over time on the basis of expected cash flows, it may be more operational and informative for the Boards to consider the need for closed pools and a focus on cash flows the reporting entity expects to receive, as opposed to cash flows it does not expect to receive. In that case, the allowance would represent unexpected shortfalls in cash flows, and the timing and amount of the allowance would have a conceptual foundation, whether for loans or securities. As noted in our previous response, recognition of income and impairment is inextricably linked. The incomplete treatment of such concepts in the Supplementary Document could create more problems than it solves.

**Question 5: Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?**

While this approach may provide decision-useful information for financial assets in open portfolios, we believe the answer to this question depends significantly on the extent and level of disaggregation of the related qualitative and quantitative disclosures, as well as on other key aspects of the impairment model that were not addressed by the Supplementary Document, such as application of the model to financial assets that are not in open portfolios and interest income recognition.

**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?**

We do not believe the differentiation between “good book” and “bad book” for the purposes of determining the impairment allowance is clearly described. For example, we believe one potential interpretation is that U.S. constituents may default to what is currently referred to as an “FAS 5 book” or an “FAS 114 book” approach and that entities applying IFRS may use the guidance for financial assets with objective evidence of impairment. Additionally, we are concerned that the definition of “bad book,” where the objective is the recovery of the financial asset, creates a threshold that is different from the definition of impaired loans in U.S. GAAP, with unknown consequences. For example, would a residential real estate loan be included in the “bad book” only when it becomes collateral-dependent?

We believe the Boards should focus on what it means to remove the “probable” threshold from existing GAAP. In other words, greater clarity is needed as to when an institution would deem a loan as impaired or classified in the “bad book.”

One option for clarifying classification within the different “books” would be to base that determination on whether the primary source of cash flows for repayment is expected to be sufficient. For example, for a residential mortgage loan, the primary source of cash flows for repayment is borrower income. However, if that source of cash flows is no longer expected to be sufficient, the primary source of cash flows would become the potential proceeds from sale of the collateral. Similarly, consider a loan on an apartment building in which the original source of repayment (rent roll) is no longer sufficient, and the lender looks toward guarantees or the collateral value of the building. Neither scenario would mean that a loss has occurred or that it is probable that a loss has been incurred, yet an entity would recognize the change in credit risk, which we believe the Boards are attempting to capture in the revised model by removing the probable threshold.

Finally, we question whether an entity should be prohibited from applying a “bad book” approach to certain loans.

**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?**

Please refer to our response in Question 6. Whether the impairment allowance is operational or auditable would depend on the clarity of the model, whether expectations of future losses can be reasonably and reliably estimated, whether the application to constantly changing open portfolios is meaningful, and whether differentiation between the two books is clarified. In addition, we believe that the ultimate operability of the impairment approach may depend on the sufficiency of implementation guidance. Our previous experience with implementation of the current impairment models suggests that the task will be exceedingly difficult and that the Boards should not leave it up to preparers, auditors, and others to provide such guidance.

**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?**

We agree with the proposed requirement to differentiate between the "good book" and "bad book" for purposes of determining the impairment allowance. However, as noted elsewhere in our comments, we believe that the two categories must be more clearly defined.

**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?**

While we agree with the principle of establishing a floor related to the "good book" based on the proposal in the Supplementary Document, we have concerns as to whether the proposal will be operational for many classes of financial assets. We believe that significant judgment, considering various factors, would be required in the determination of whether and when a credit loss is expected to occur. For example, such determination may consider what interest rates are projected to be over the next 12 months or where prices are expected to go over the next 12 months. We believe that there may be alternatives to a floor for the "good book," such as segmenting the loan portfolio based on seasoning of the loans when measuring the allowance for loan losses

Additionally, measuring a floor would require determination of when a loss occurs and when that loss may be confirmed (charged-off). While this may be operational for groups of certain homogenous financial assets, we do not believe that this would be operational for all financial assets when applying the broader concept of a minimum allowance.

We believe that the question should not be whether there should be a floor, but rather what should the allowance represent or measure. In other words, should the allowance represent all expected future losses in the portfolio, losses expected in the foreseeable future, or something else? Addressing this fundamental question may eliminate the need to establish what appears to be a “bright-line” floor of a minimum 12 months.

- (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?**

No. Economic events may give rise to a pattern of increased losses in the near term and may occur at any time in the life of a portfolio of loans.

- (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?**

While we agree with the principle of establishing a floor related to the “good book” based on the proposal in the Supplementary Document, we note that certain factors that would be included in the determination of a future loss estimate will vary, depending on the time horizon under consideration. Also, refer to our response to Question 9(a).

- (d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?**

We generally believe that the period to be considered in developing the expected loss estimate would not change on the basis of changes in economic conditions. However, the economic conditions may change so rapidly or significantly that it may be inevitable that the period considered would need to change. Accordingly, we recommend that the Boards not close the door on this issue, but rather require an entity to disclose why the period used changed and the impact of the change, similar to the disclosures required for other changes in accounting estimates.

- (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.**

We believe that the foreseeable future period would typically be a period greater than twelve months. However, as noted in our response in 9(c), certain future loss factors that would go into the determination of a loss estimate will vary, depending on how far in the future one would be able to reasonably estimate such loss factors, and this will impact the length of the period. Also refer to our response in 9(d).

- (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.**

We do not agree that a “ceiling” should be established for determining the amount of credit impairment to be recognized. Rather, we believe that the issue of comparability could be addressed by specifying what factors should be considered in income and impairment recognition and by clarifying how much weight should be applied to those factors. In other words, we would expect that greater weight would be placed on factors that are six months out as opposed to factors two years out. Also, this question illustrates the importance of addressing the conceptual question of the intended meaning of the allowance, something we believe is an overarching objective that the Boards must address.

**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.**

We believe that this answer will depend on various factors including, but not limited to, the current economic environment, the type of financial asset (for example, losses for certain types of loans may be more likely to occur during the first few years of the loan’s contractual life), and the underwriting of the loan.

**Question 11: The boards are seeking comment with respect to the flexibility related to using 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?**

We do not agree with the flexibility related to using discounted amounts and believe that the time-proportional expected credit losses should be based on a discounted loss approach. We also believe that a discounted loss approach should be applied to the “bad book” measurement.

- (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?**

Yes, we agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount.

**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?**

We do not prefer the IASB's approach for open portfolios of financial assets measured at amortized cost to the common proposal in the Supplementary Document. As noted above, we believe that such an approach would not address the issue of delayed recognition of credit losses identified by the Boards. Similarly, we do not agree with the general IASB approach of recognizing expected losses over the life of the assets, as this would potentially result in the overstatement of an asset or delayed impairment recognition.

**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?**

We do not prefer the FASB's impairment approach to the common approach proposed in the Supplementary Document. Similarly, we do not prefer the general concept of the FASB's approach of recognizing credit losses expected to occur in the foreseeable future.

## Responses to IASB-only Appendix Z: Presentation and Disclosure Questions

**Question 14Z: Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?**

We agree that the determination of the effective interest rate should be separate from the consideration of expected losses. We believe that the Board's original proposal of an integrated effective interest rate (incorporating expected credit losses) reflects the economics of lending activity. However, we are also aware that such an integrated rate would be operationally burdensome to implement as accounting and risk management systems are maintained separately in practice. We therefore support the use of a non-integrated or "decoupled" effective interest rate on practical grounds.

**Question 15Z: Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?**

We assume this question concerns the application of an expected loss approach to portfolios of loan commitments from the potential lender's perspective, and have answered it in that context. We note in passing that impairment is normally considered in relation to assets, whereas written loan commitments are of course liabilities.

We support using consistent methodology to estimate credit losses on loan commitments if such estimates are required as part of the applicable accounting model. However, we think that further consideration is needed on when and how credit losses are recognised in relation to written commitments. Under the existing requirements, a loss is recognised in accordance with IAS 37 only for those commitments that are determined to be onerous (generally those for which a loss is "probable"). In effect, therefore, an impairment "trigger" exists. A model that eliminates any impairment loss trigger for (otherwise) unrecognised loan commitments raises different issues in comparison to recognised loan assets.

It seems counter-intuitive to recognise all expected losses in a portfolio of potential future loans independently, and in advance, of recognising any benefits from those future loans. Such an approach would seem to give rise to "day 1" losses each time a commitment is written.

**Question 16Z: Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?**

We believe that estimating credit losses (using the proposed model) for loan commitments may raise additional challenges because such commitments arise at an early stage in the lending process. We are not aware of other, specific operational problems. We note that loans and loan commitments are often managed using the same risk management systems.

Additional challenges may also arise in estimating expected losses for financial guarantees. Issuers will be required to estimate losses on another entity's debt asset, as opposed to its own debt assets (loans). It may be more difficult to obtain the necessary data in these circumstances.

Overall, however, we suggest that it is primarily for preparers to comment upon whether the proposed requirements will be operational for these types of contract.

**Question 17Z: Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?**

We agree. We believe the proposed presentation requirements are consistent with the revised proposals for a non-integrated effective interest rate.

As discussed in our response to Question 14Z above, we support the use of a non-integrated or "decoupled" effective interest rate on practical grounds. Should the proposal for the use of such an effective interest rate be accepted, then it will no longer be possible to adopt the presentation requirements proposed in the original Exposure Draft. We therefore support the presentation requirements in the Supplementary Document, which are consistent with the use of a non-integrated effective interest rate.

**Question 18Z: (a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why? (b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?**

In our response to the original Exposure Draft, we criticised the proposed disclosure requirements for being overly prescriptive. We also expressed a preference for entities to have more discretion to disclose only those matters which are relevant to an understanding of the entity's financial performance and position.

Given these concerns, we agree with the more flexible approach set out in BZ19 in the proposed Application Guidance. This states that an entity should decide, in the light of its circumstances, how much detail it provides, how much emphasis it places on different aspects of the requirements, and how it aggregates information.

We also agree with the intentions that underlie the proposed disclosures relating to the allowance account, expected credit loss estimates, and credit risk management. The proposed disclosures should help improve the user's understanding of the effects of credit risk on an entity's financial instruments.

Although we acknowledged the Board's efforts to adopt a more flexible and principles-based approach to disclosure, we remain concerned at the overall volume of proposed new requirements across recent Exposure Drafts relating to financial instruments. While many proposals are supportable individually, they may result in considerable additional burdens when considered collectively. We are concerned both by the impact on entities' preparation costs and potential for "information overload". We therefore encourage the Board to undertake an overall review of IFRS 7, *Financial Instruments: Disclosures*, as soon as it has concluded its work on IFRS 9 so as to ensure that IFRS 7's disclosure requirements remain principles-based and strike an appropriate balance.

**Question 19Z: Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?**

We agree. Such an approach should improve comparability and should therefore provide useful information to the users of the financial statements.

May 5, 2009

**Mr. Timothy F. Geithner**  
**Secretary of the Treasury**  
**U.S. Department of the Treasury**  
**1500 Pennsylvania Avenue, NW**  
**Washington, D.C. 20220**

*Audit - Tax - Advisory*

Grant Thornton LLP  
1900 M Street NW, Suite 300  
Washington, DC 20036-3531  
T 202.296.7800  
F 202.833.9165  
[www.GrantThornton.com](http://www.GrantThornton.com)

**Dr. Ben S. Bernanke**  
**Chairman**  
**Board of Governors of the Federal Reserve System**  
**20th Street and Constitution Avenue, NW**  
**Washington, DC 20551**

**Ms. Sheila C. Bair**  
**Chairman**  
**Federal Deposit Insurance Corporation**  
**550 17th St., NW, Room MB-6028**  
**Washington, DC 20429**

**Dear Secretary Geithner, Chairman Bernanke and Chairman Bair:**

In recent months, the impact of fair-value accounting (also known as mark-to-market accounting) on financial institutions and the capital markets has been the focus of considerable controversy. An equally controversial topic is the manner in which banks record losses in their loan portfolios. Both issues hinge on two factors:

1. Investors' right to and need for transparent and objective financial information that accurately presents corporate performance in a comparable form across various investment opportunities; and
2. The effect that financial statements prepared in accordance with generally accepted accounting principles (GAAP) have on regulatory capital requirements — as well as the corresponding effect those requirements have on the operations of financial institutions, including banks and other financial institutions.

Grant Thornton LLP supports the position that additional guidance by the Financial Accounting Standards Board (FASB) was necessary in order to address certain misunderstandings and inconsistencies in GAAP. To that end we believe the prompt action taken by FASB in early April regarding fair-value measurements and other-than-

temporary impairments was appropriate. However, we believe that greater opportunities exist *within the current regulatory framework* to address the continued perception by some that current GAAP needs further revision — opportunities that, if acted upon, will preserve investor information, enhance the safety and soundness of our financial institutions and provide a level of stability and predictability that financial institutions, investors, regulators and other stakeholders will value.

This letter is intended to provide a broad outline of our proposal, which is centered on the two core issues of fair-value accounting and the allowance for loan losses.

### **Fair-Value Accounting**

Some financial institutions believe that fair-value accounting forces them to write down certain financial assets to a level below the value they expect to recover in the long term. Further, they assert that these write-downs compel them to curtail lending activities, preserving capital solely to meet certain regulatory requirements. Their proposed changes, even after considering FASB's recent actions, often involve suspending fair-value accounting or modifying it such that management may calculate and report its own estimates of "fair value" with minimal regard for current sales prices in the marketplace. The likely result will exceed the value calculated using recent sales prices of similar assets.

Other stakeholders, including investors (who are the primary users of financial statements) and auditors, believe that properly applied fair-value accounting provides the most transparent picture of the relative financial condition of an organization. This level of transparency enables investors to compare more effectively similarly situated organizations — even in a declining market — thereby facilitating the allocation of investment capital to the best performers. Investors rightly fear that overly minimizing or eliminating recent sales prices from the fair-value equation will reduce significantly their ability to analyze company performance and make wise investment choices. This limitation subsequently reduces their willingness to invest in the very institutions that so urgently need private capital investment.

Many of the arguments for and against fair-value-accounting are legitimate. In extreme economic times — positive or negative — fair-value accounting that relies heavily on recent sales prices will, at some point, price-in either irrational exuberance or irrational fear. In other words, the influence (real and psychological) of recent sales prices in these environments will not reflect reasonable expected future cash flows. Investors, on the other hand, are justified in demanding transparency and objectivity in the financial-reporting process. Just as banks today require a recent independent appraisal before making a home loan, investors in those banks have a right to know how the marketplace values the bank's financial assets.

We believe that prudential regulators can play a much greater role in addressing any remaining concerns regarding application of fair-value accounting principles with respect to financial institutions — a role that will (1) protect more effectively the safety

and soundness of financial institutions that are vital to the economy; (2) discourage excessive risk-taking in a booming economy; (3) provide necessary capital cushions in a declining economy; and (4) still provide the financial-statement transparency and objectivity needed by investors. The solution we propose — which includes encouraging regulators to utilize dynamic regulatory capital requirements — has been mentioned in various hearings and news articles, but nowhere have we seen (1) its broad benefits expounded upon or (2) its practical implementation discussed. We seek to do both in the remainder of this letter.

### **Dynamic Regulatory Capital Provisioning**

The capital requirements for regulated financial institutions are static, regardless of the economic climate and the degree of systemic risk created by each entity.<sup>1</sup> In order for a bank to be considered “well capitalized,” for example, the minimum ratio of total capital to risk-weighted assets is 10 percent. This ratio has been constant since the establishment of the current bank regulatory capital structure in the early 1990s. From time to time, regulators have changed the risk weightings of certain assets in that calculation, but the overall minimum ratio has remained constant in both up and down markets. However, in the midst of today’s economic crisis, we see clearly that many banks do not have adequate capital to enable them to operate their core business rationally. In retrospect, had the banks (especially those that create systemic risk to the entire banking system) built up greater capital cushions in the best economic times, they would now have an adequate cushion for weathering the bad times.

We propose that bank regulators exercise their authority to adjust capital requirements to account for different economic environments, thus providing “dynamic regulatory capital provisioning.” Taking this approach would increase capital requirements in booming economies and decrease those requirements in strained ones. The advantages of such an approach are many:

1. In prosperous economies, financial institutions often invest in increasingly risky assets in order to drive income and compete in the marketplace. An increase in the overall capital requirements in such economies would serve as an effective braking mechanism by reducing the capital available for potentially excessive risk-taking. Further, the reduction in excessive risk-taking would redirect public investment in these institutions toward investors who look for long-term value creation rather than short-term earnings.
2. In struggling economies, the additional accumulated regulatory capital would provide the necessary cushion and time frame for institutions to absorb losses and hold, or seek more orderly liquidation of assets. This process would, in turn, prevent dramatic declines in sales prices (and, thus, fair value) across other institutions.

---

<sup>1</sup> The announcement of increased capital requirements for certain financial institutions as a result of the recent stress tests is an exception to the long-standing static nature of capital requirements.

3. The counter-cyclical declining capital requirements in weak economies would enable financial institutions to operate their core lending businesses rationally, without limiting them to capital requirements better suited to stable economic environments.
4. GAAP would be separated more effectively from the regulatory capital requirements, thereby enabling investors to have the information they need while at the same time providing regulators the tools they need to properly monitor financial institution safety and soundness.

Regulators can attain the goal of dynamic regulatory capital provisioning in several ways:

1. By working with financial institutions, finance professionals and the academic community, regulators can develop a set of global and national economic thresholds (with corresponding triggers) designed to raise or lower capital requirements for all institutions in a given group (e.g., commercial banks and savings banks and/or thresholds based on size and level of systemic risk). Similarly situated institutions could then be treated in the same way, providing a level of predictability about the direction of capital requirements for financial institutions and their stakeholders.
2. The counter-cyclical changes in capital requirements could be spread over a longer period of time in up markets and allow for faster adjustment in down markets. This approach would minimize the shock of increasing requirements, while simultaneously allowing for prompt adjustment during a downturn — a time when capital is being used to absorb losses.
3. Regulators can develop a more robust and transparent process for establishing and adjusting the risk weightings of assets that are included in the capital ratio calculations. With the ability to evaluate new financial instruments quickly, regulators will have greater flexibility in modifying the calculation of capital ratios as complexities and risks change in the investment landscape. The process might include criteria for establishing risk weights, as well as a public exposure period to solicit valuable feedback on proposed changes in the capital ratio calculations.
4. As a last resort, regulators should be ready to require changes to an individual institution's capital requirements (changes either in the form of the calculation or in the required ratios) if certain risk characteristics exist. Such characteristics might include systemic risk indicators, the results of recent regulatory examinations, and the presence of highly unusual operating statistics or unusual transactions with a high degree of risk.

## Allowance for Loan Losses

Bankers, and particularly regulators, desire to build loan-loss reserves in good times so that those reserves can be used to cushion the blow in bad times — a model often referred to as “dynamic loan-loss provisioning.”<sup>2</sup> Industry jargon often refers to these provisions as “cookie-jar reserves.” From the standpoint of taking prudent action to prepare for unknown future losses, the “cookie-jar reserve” approach is difficult to dispute. It does indeed have merit from a safety and soundness perspective, but only because it creates a *disguised* form of capital held in the allowance account, rather than in the capital accounts. For investors, however, it has serious negative consequences.

Imagine a baseball team that is allowed to transfer runs from a game against a weaker opponent to another game against a stronger opponent. Related box scores would lose their meaning. Likewise, financial statements with smoothed earnings do not provide an adequate picture of performance for investors.

In this way, building reserves in good times and using them in bad clouds reality for investors and lowers their overall confidence in the system. A banker who uses excess allowances to smooth earnings in down years could be masking poor management decisions rather than simply responding to a downturn. Because investors have no way of knowing the truth, they typically perceive their risk to be greater, a belief which translates into higher cost of capital. Some assert that allowances with built-in cushions protect the bank, but the reality is that allowances *don't* protect the bank from losses; they only protect reported earnings from larger loss provisions in periods when the losses actually occur. To a degree, then, they protect management and regulators, not the bank. Indeed, the very existence of a cushion to earnings may *encourage* more reckless investment and lending activity.

Dynamic regulatory capital provisioning, as outlined in our proposal, can solve the dilemma without changing GAAP to allow for income-smoothing. Loan losses would be charged against earnings as they occur, but the increases in capital requirements in good times would provide the desired cushion in bad. Declining capital requirements would offset increases in loan-loss allowances when incurred losses are recognized in the financial statements.

## Conclusion

All stakeholders benefit from steps taken to (1) ensure the transparency and objectivity of financial information for investors, and (2) improve the safety and soundness of our financial institutions. Unfortunately, steps taken to attain certain objectives sometimes impede the ability to attain others. All of the objectives presented here, however, are attainable.

---

<sup>2</sup> “Dynamic loan-loss provisioning” is contrasted with our proposed “dynamic regulatory capital provisioning.” The former distorts financial statements and prevents their transparency in providing investors with important financial performance information. The latter puts the dynamic-provisioning tool in the hands of regulators, thereby enabling them to protect more effectively the safety and soundness of the institutions they regulate.

GAAP provides a solid foundation of information for investors. It is not perfect and should be amended when and where necessary for the purpose of furthering investor information needs. Its wholesale abrogation in order to achieve certain operational objectives should be avoided — especially as we have better alternatives in the form of counter-cyclical changes to regulatory capital requirements. By exercising their ability to change regulatory capital requirements — increasing the requirements in good times and decreasing them in bad — prudential regulators can provide predictable, behavior-changing parameters that would minimize risk-taking on the upside and maximize much-needed capital on the downside.

We at Grant Thornton encourage a greater exchange of ideas related to this matter and look forward to participating in its resolution. If you have any questions, please contact R. Trent Gazzaway, Managing Partner of Public Policy and Corporate Governance, at 202.521.1545 or [Trent.Gazzaway@gt.com](mailto:Trent.Gazzaway@gt.com).

Sincerely,

/s/ Grant Thornton LLP

cc:

Board Members of the Financial Accounting Standards Board  
Board Members of the Public Company Accounting Oversight Board  
Commissioners of the Securities and Exchange Commission  
Members of the House Financial Services Committee  
Members of the Senate Banking Committee