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Financial Accounting Standards Board (FASB)
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Proposed Accounting Standards Update, Financial Instruments—Credit Losses (Subtopic 825-15)

Dear Director:

I appreciate the FASB's attempt to improve accounting standards relating to the recognition of credit losses. However, proposed ASU Subtopic 825-15 ("the ASU") creates more problems than it solves and will make financial statements less relevant and useful. The ASU's central principle--the measurement of all future cash flows, potentially over the entire "life of the loan"--is flawed for reasons discussed below, and it should be withdrawn or substantially modified.

The current accounting "incurred loss" model, if applied robustly and supplemented by adequate disclosures of fair value and credit loss indicators (such as disclosures of classified assets, allocations of reserves by loan type, TDRs, etc., many of which have been added by FASB in recent years), is more reliable, accurate and relevant for financial statement users and preparers, as well as regulators.

I also disagree with the premise that the current "incurred loss" model failed in the financial crisis and that adopting a more aggressive, forward looking "expected loss" model will improve the credibility and reliability of financial statements.

I WANT THE FASB TO GET IT RIGHT BECAUSE I DEAL WITH IT EVERY DAY

I am the CFO of Workers Credit Union headquartered in Fitchburg, MA. Although our financial statements do not receive the same level of scrutiny as publically held financial institutions our reporting cycles are exactly the same and we must follow the same rules. As a state chartered and federally insured credit union we have annual audited financial statement requirement, quarterly reporting requirements to the National Credit Union Association (NCUA) and monthly reporting to our board of directors. Our credit union has performed well throughout the period you cite as the cause for a change in the manner of reporting credit losses and none of the users of our financial statements have noted any deficiency in their understanding how we reported credit losses.

I am also a CPA (TX) who worked for more than 15 years at KPMG and PWC (1983-2001) as an auditor and consultant to primarily financial institutions. During this time I gained valuable experience in the evaluation of credit losses as I witnessed the failures and bailouts of numerous banks while working as an auditor in Texas.

I DISAGREE WITH THE PREMISE THAT THE CURRENT "INCURRED LOSS" MODEL IMPROPERLY DELAYED CREDIT LOSS RECOGNITION DURING THE RECENT FINANCIAL CRISIS

Using FDIC data on the entire banking industry (www.fdic.gov), I have examined the timing of loan loss provisions (LLPs), net charge offs (NCOs), nonperforming assets (NPAs) and loan loss reserves (LLRs) for each quarter before, during and after the crisis. While many individual financial institutions were clearly "behind the curve" on recording timely credit losses, as evidenced by the fact that many are still recording credit losses that appear to have been incurred several years ago, that is not due to bad accounting principles, but bad accountants. For the banking industry as a whole, the data show that the industry accrued and recognized LLPs and built LLRs in advance of actual NPA formation and NCOs, as appropriate, as shown by the following:

- The banking and credit union industry built reserves rapidly as things began to worsen, as appropriate, as evidenced by the ratio of LLPs to NCOs banks **peaked at 198% in Q4 2007, as the recession was just beginning** (a fact that was not known except in hindsight; recall that NBER did not even officially define December 2007 as the beginning of the recession until one year later, in December 2008) credit unions **peaked at 143% in Q4 2008**
- Banks **LLPs peaked in Q4 2008**, six months before the recession ended in June 2009 (a fact not known officially until 15 months later) and well before **NCOs peaked one year later in Q4 2009 and NPA's peaked two years later in Q1 2010** (all in total dollars) Credit union LLPs peaked in June 2009 with both NCO and NPA's peaking six months later

As shown above, the industry recorded LLPs and built LLRs on an accrual basis, using forward looking information, ahead of the recession and actual NPA formation and actual NCOs, as appropriate, in my opinion.

On 12/31/06, the banking industry had LLRs that equaled 268% of NPAs. Arguably the industry was significantly **over-reserved**, given the information that was available or reliably predictive at that time. Would the financial statements in 2004, 2005 and 2006 been more accurate or relevant if that ratio was 400% or 500%, as accountants reached into the future to record potential future credit losses that may or may not have happened? What if the financial crisis had not happened? Look at the period following the 9/11 attacks. Many respected forecasters predicted huge losses for the economy and the banking industry in 2002 and beyond. Instead, we had a boom in real estate and some of the lowest loan losses in years that lasted for 5 years.

And let's not forget that coming into the financial crisis, the SEC and accounting standard setters were concerned that banks were padding future earnings by over-reserving current credit losses (recall several high profile SEC investigations in the mid-2000s).

RECOGNIZING CREDIT LOSSES WHICH MAY OR MAY NOT OCCUR UNTIL WELL INTO THE FUTURE IS PREDICTION, NOT ACCOUNTING

Only in hindsight can economic events, markets and credit losses be defined with any certainty. While I do not advocate a "pay as you go" credit loss model, I do not believe accountants or any other financial statement preparers can predict economic events well into the future any more than analysts and economists can predict the stock market, interest rates or the economy with any degree of precision that would qualify as sufficiently reliable for use in financial statements. Everyone is entitled to an opinion and a forecast, except accountants when they prepare financial statements. It's hubris to think anyone can predict the cash flows or losses on a loan years into the future.

I want financial records, not financial forecasts, in financial statements. I will read economist's forecasts in newsletters if I want to peer into the future.

While I am sure the FASB staff will say that they are only asking preparers to reach out into the foreseeable future for cash flows that are measurable, I can only say that it is an inherently flawed and impossible request, particularly when the ASU explicitly forbids the use of probabilistic or statistical models. The diversity of results that different preparers, using the same fact pattern(s), will generate under the ASU will be too great to make financial statements comparable or reliable.

THE ASU EFFECTIVELY WANTS "LIFE OF LOAN" ACCOUNTING, BUT IT ONLY COUNTS ONE SIDE OF THE CASH FLOWS, WHICH IGNORES THE MATCHING PRINCIPLE AND DISTORTS FINANCIAL RESULTS

All loans, except risk-free loans (if there is such a thing), include an interest rate that is in part, compensation for credit risk. The higher the credit risk, the higher the interest rate, is the general rule. The ASU fails to account for these credit absorbing interest cash flows, which will only be recorded in future earnings statements as the interest income is received, while forcing the recording of the "life of loan" or its practical equivalent in credit losses upfront, a clear violation of the matching principle.

Let's use an example. A bank originates a new 6% 10 year loan (well above risk free rate of say 2% on 10 year treasuries) on an office building that is underperforming due to below market leases. While the bank does not expect credit losses on the loan based upon what it currently knows about the loan (meaning no reserves would be booked except perhaps a FAS 5 general reserve under current accounting standards), under the ASU "life of the loan" method (my term, not the FASB staff), it would likely have to book a large measure of credit loss upfront, on the whole portfolio of similar loans, if not on this one loan in particular. However, the ASU would fail to account for the inherent 4% "excess" interest revenue (since the ASU requires the loan's effective—i.e. stated—interest rate as the discount rate) in the cash flow analysis. So, the interest revenue would dribble into the P&L over 10 years, while the credit loss would be booked upfront or at least in lumps in the year when credit losses are forecasted. This is not good accounting and violates the matching principle. While I acknowledge that this inherent mismatch is also somewhat true in current loan loss accounting and interest income recognition, the problem is exacerbated by the ASU because it wants accountants to employ life of loan cash flow estimates.

THE BANKING INDUSTRY ALREADY HAS "LIFE OF LOAN" LOSS RESERVES; IT'S CALLED CAPITAL

The banking industry already has "life of loan" reserves in its financial statements; it's called capital. Capital and reserves are very similar. They are both available to absorb losses. That is why analysts and regulators use ratios such as the Texas ratio (which compares NPAs to LLRs + capital). Allocating more capital to LLRs by employing highly subjective and inherently inaccurate "life of loan" estimates does not improve the quality of income statements or balance sheets. Capital, through earnings, should only be appropriated for loss reserves when a loss is probable and estimable or has already been incurred. Periodic income statements should reflect current events (including accruals for liabilities and costs which are probable and estimable or have been incurred), not inherently unreliable forecasts of cash flows years into the future.

Regulators here and abroad (Basel 3) are already requiring significant excess capital and changes to risk-based capital rules, to build significant cushions for future financial crises. If the FASB adopts the ASU's aggressive loss recognition model, the banking industry will effectively be paying 2x or 3x for the same losses, even though those losses may never be incurred (FASB staff must recognize that regulators do not let banks ever use capital without replacing it, so booking loan losses upfront will

require more capital raising). This will hurt the economy and bank stock valuations, without any improvement in the reliability and relevancy of financial statements. A lose-lose-lose.

FORECASTING FUTURE "WHAT IF" SCENARIOS IS A JOB FOR ANALYSTS AND REGULATORS NOT ACCOUNTANTS

As an analyst of bank financial statements, I can do my own "what if" projections of future loan losses (and income) to properly analyze what future earnings and capital levels might be under different economic and loss scenarios; but that is not accounting. I want accountants to tell me what "has happened," not what "might happen." The "might happen" is my job, and that of other users, who if given proper disclosures can do a credible job of forecasting a range of future results using their own factors and judgments.

ACCOUNTING PRINCIPLES SHOULD WORK IN ALL ECONOMIC AND MARKET ENVIRONMENTS, NOT JUST IN SEVERE, UNPREDICTABLE FINANCIAL CRISES THAT MAY OR MAY NOT OCCUR

The FASB should produce accounting principles which work in all environments, not just in periods of crisis. While it's always wise to employ conservative loss reserving methods, building a LLR sufficient to withstand another 2008-2009 type worldwide financial crisis is by definition a model that is inappropriate in all other periods before and after that crisis. Echoing an earlier comment, that is a job for company managements, boards of directors and regulators through capital management and regulation, not accounting principles.

If the banking industry had built up excess reserves sufficient to handle most or all of the losses incurred in the most recent financial crisis, the prior years' and subsequent years' financial statements would have been inaccurate and unreliable, leading to real life costs and problems where none existed. The ASU is not the solution.

Existing accounting principles, if properly and conservatively applied, supplemented with appropriate disclosures (most of which have already been appropriately enhanced in recent years) are already sufficient to produce reliable and credible financial statements. I strongly recommend that the FASB withdraw or substantially modify the ASU.

Please note that the comments contained herein are mine and mine only, and do not reflect those of my investment firm or any company or person that I am affiliated with.

Regards,



J Timothy Smith