



Credit Union National Association

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

Re: Comments on Proposed Accounting Standards Update: Financial Instruments—Credit Losses; File Reference No. 2012-260

Dear Chairman Seidman:

This comment letter represents the views of the Credit Union National Association (CUNA) regarding the Financial Accounting Standards Board's (FASB) Proposed Accounting Standards Update on "Financial Instruments – Credit Losses (Subtopic 825-15)."

CUNA commends the FASB's decision to extend the comment period on the proposal. We also sincerely appreciate the opportunity we had to meet with Mr. Russell Golden, incoming FASB Chairman, to discuss credit unions' concerns regarding the proposal.

By way of background, CUNA is the largest credit union advocacy organization in the country, representing approximately 90% of the nation's 7,000 state and federal credit unions, which serve over 96 million members. This comment letter was developed under the auspices of the CUNA Accounting Subcommittee with significant input from the CUNA CFO Council (comprised of chief financial officers of member credit unions from every state), other credit union representatives, and State Credit Union Leagues.

Summary of CUNA's Position

After reviewing the proposal in detail with our members, accountants, and others, CUNA strongly opposes the proposal and urges the FASB not to proceed with the accounting standards update as issued for comments. The key points of our comment letter are:



- CUNA has concluded that the proposal would be detrimental to the credit union system, and could have serious, unintended consequences for borrowers and the economy.
- CUNA seriously questions whether the proposal will achieve the FASB's stated objectives.
- CUNA also questions how the proposal will be reconciled with the proposed approach from the International Accounting Standards Board.
- Some have concluded that the current methodology for recognizing credit losses did not identify such losses at the largest financial institutions soon enough leading up to and during the financial crisis. However, there is no evidence that the current system is not working well for smaller institutions, including credit unions.
- It is our understanding that a number of other stakeholders oppose the proposal as well, and CUNA urges the FASB to be responsive to the range of comments that raise material issues of concern about the proposal.
- CUNA urges the FASB to recognize the differences between credit unions and other providers, particularly the largest banks who actively participated in activities that contributed to the financial crisis.
- CUNA further urges the FASB to allow credit unions to continue reporting under the current methodology, which has not been shown to be problematic for the credit union system.
- If that is not feasible, it is our strongest hope that the FASB will work with the credit union system to develop credit loss reporting standards for credit unions, separate from those for publicly traded companies, that will reflect the unique business model of credit unions while ensuring credit loss issues are reported appropriately.
- Should the FASB determine that it must approve the proposal and apply it to all financial institutions and other covered entities regardless of whether they are publicly traded, CUNA urges the FASB to incorporate the changes discussed in this letter before the proposal is issued in final form.

In Order to Promote Transparency and Accuracy of Financial Reporting, Accounting Requirements for Credit Unions Should Reflect Credit Union Distinctions

I believe that in order for the FASB to appreciate fully credit unions' concerns regarding the current proposal, it is imperative that the FASB understand the unique structure of our nation's credit unions. Thus, before discussing specific issues CUNA has with the FASB's proposed accounting standards update, I would like to highlight some important differences between credit unions and publicly traded institutions, which I hope are useful to the FASB as it considers the impact of its proposal on stakeholders such as credit unions.

The business model of credit unions is very different from that of for-profit banks and other publicly traded entities that would be subject to the proposed standards update. Credit unions are member-owned, democratically controlled institutions. Each member generally has one vote regardless of the size of his or her account. Credit unions are also not-for-profit financial cooperatives – they are the only financial institutions in this country that operate under this model.

There are no stockholders in credit unions, and because of that, credit unions are not driven by the need to maximize profits for investors. Instead, credit unions operate for the purpose of promoting thrift, providing credit, and offering other consumer and small business financial services to their members and communities at favorable rates.

Likewise, because of credit unions' business model, their regulators and members – who are more analogous to bank depositors than to bank stockholders – are the stakeholders for their financial information, not investors.

Credit unions differ from other financial institutions in this country in another significant way. Under the Federal Credit Union Act (FCU Act), a credit union's net worth is limited to its retained earnings. (This is the case for all credit unions except those that are designated by the National Credit Union Administration (NCUA) as Community Development Credit Unions (CDCUs). (There are about 244 CDCUs, which predominantly serve low-income areas, and their median size is about \$3.8 million.)

Because of the provisions in the FCU Act regarding the composition of credit unions' net worth, the ability of NCUA as the supervisor of all federally insured

credit unions to adjust its regulations on net worth requirements in response to changes in accounting standards is not allowed, even though it is possible for other federal financial regulators to make such adjustments under their rules. This is significant considering the proposal's likely impact on credit unions' Allowance for Loan and Lease Loss accounts (ALLL), which is addressed in greater detail below.

In light of these important and highly relevant distinctions between credit unions and publicly traded institutions, and in order to facilitate financial reporting that is the most accurate, credit unions' financial statements and financial reporting should reflect the uniqueness of credit unions and who the end users of their financial statements are, rather than requiring credit union reporting to meet standards designed to address problems presented by the for-profit bank model. Moreover, credit unions should not be required to conform to accounting standards that are more appropriate for publicly-traded banks and other stockholder companies when such standards will impose significant costs and hardships on credit unions and their communities as the current proposal would do, if adopted.

Overview of the Proposal

Lending to members who are consumers or small businesses is a core function of credit unions and thus, how credit unions must report and reserve for credit losses is of utmost significance to them. The FASB's proposal, which would change the methodology for recognizing credit impairment, is the most critical regulatory concern credit unions have faced in quite some time, including rules or proposals that have been issued under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The current model used by most credit unions generally calls for recognition of credit losses when such a loss is considered "probable." Based on this model, credit unions maintain reserves in their ALLL accounts based on historical loss data, cash flow calculations and qualitative and environmental factors, reflecting expectations of losses and losses that have been incurred and will be charged-off during the next 12 months after the last reporting period.

Under the proposal, covered entities will be expected to estimate the present value of cash flows associated with all loans and other assets that are not expected to be collected over the life of the loan or asset. The reporting entity

would consider past events, current conditions, historical loss experiences, the borrower's credit worthiness, forecasts of expected credit losses and predictions about the economy. Credit loss reporting would not reflect a worst-case scenario or a best-case scenario and could not be based solely on the most likely outcome, even though financial reporting on that basis seems to be reasonable and rational.

As a result of the proposed changes in how credit losses would be evaluated, the proposal would require credit unions to provide information that is not relevant to the primary users of credit unions' financial statements, who are primarily the NCUA, state credit union regulators, and credit union board members.

Credit unions feel that their end users are not interested in credit loss estimates that are based on subjective projections regarding cash flows. (They may question why the credit union is making the loan in the first place if the credit union projects that payments will not be made.) They are interested in the credit union's reasonable analysis of the performance of its loans based on analytical components, such as under the current incurred loss model, and the extent to which the credit union has provisioned its ALLL account to reflect loan nonperformance.

The FASB's stated intent behind issuing the proposed changes is that the current impairment methodology does not allow for the timely recognition of credit losses. There is no empirical evidence to support this concern for credit unions generally. In fact, the current and continuing robust health of the credit union system, despite the financial crisis, supports CUNA's view that the vast majority of credit unions have been able to deal with credit impairment utilizing the present incurred loss approach. Also, while a limited number of credit unions did experience losses and a smaller number failed in connection with the financial crisis, to the extent accounting issues were involved, NCUA's Inspector General's material loss reviews support a conclusion that there was a misapplication of the current incurred loss methodology by the problem credit union, not the need for a new approach for credit unions.

Directly as a result of the financial crisis, five corporate credit unions failed and were ultimately taken over by NCUA (two in 2009 and three in 2010). These institutions were wholesale providers of support services and products to credit unions that serve consumers and small businesses. This small group of institutions invested in faulty mortgage backed securities that helped lead to their demise but other issues also contributed to their downfall, including recognition of other than temporarily impaired assets, which are not relevant to our discussion regarding the FASB's proposal. Since then, NCUA has restructured corporate credit unions and made broad changes in the way it regulates and supervises

corporate credit unions. In any event, investment and other problems these institutions experienced have been addressed.

Moreover, it is far from clear that the proposed approach would have been effective at preventing credit losses in credit unions or the losses within the banking system that were magnitudes greater over the past several years. That is because there is widespread concern that it is not possible for covered entities and their accounting practitioners to predict the extent and timing of the type and scope of credit events that led to the widespread losses banks faced.

Potential Impact of Proposal on Credit Unions

The proposal would require credit unions to recognize on the balance sheet, current loss expectations in their ALLL accounts. Thus, upon becoming effective, it is estimated that the proposed changes would cause an immediate and drastic increase to the ALLL accounts of credit unions under the broad scope of the proposal. This increase, which could double or even triple current ALLLs, would result directly in a reduction of retained earnings for many credit unions.

A decrease in earnings could lead to a lower net worth ratio, which could trigger prompt corrective action (PCA) implications for numerous credit unions that currently do not have PCA concerns.

There is also a concern that the proposed current expected credit loss (CECL) approach could result in quarterly adjustments in expected loss projections, possibly resulting in even more volatility in reported earnings. Another possible result of the proposal is that reporting entities could take large one-time charges at first signs of distress in their loan portfolios, and then look for opportunities to smooth earnings' out over time through reserve releases or reverse provisions.

The proposed changes could also ultimately result in the consolidation of credit unions that have difficulties complying with these changes. Such a result would not only affect the members of those credit unions directly involved, but would affect the larger financial services marketplace by reducing consumer financial options.

We do not know if these concerns would materialize if the proposal is adopted, but the problem is that no one knows for sure that they will not.

One result of the proposal that is certain is that it will require credit unions to expend extensive financial and technical resources to even begin to comply with the changes proposed, particularly to be able to forecast future credit losses. The costs of any such expenditures will be borne by credit unions' member-owners.

Further Challenges & Impediments to Complying with the Changes as Proposed

The proposed CECL model effectively requires entities to predict the extent and timing of future impairments. Predicting such losses with any degree of accuracy will be extremely challenging, even for an entity with adequate data sets and modeling capability. Further, attempting to predict credit loss for the life of a loan will inherently be affected by the subjectivity of and assumptions made by the reporting entity.

In regard to the data necessary to conduct such modeling, even the largest financial institutions have indicated that they do not have adequate information on this data and that it will take years (some estimating four to five years) to obtain. Further, since smaller financial institutions will require even more time to obtain such data, these institutions may have to rely on their larger counterparts for data, which will result in a delay in receipt of information. In addition, even after smaller institutions obtain adequate data, some practitioners are estimating it may take up to four more years for these institutions to become comfortable with the required modeling.

While credit unions currently maintain data similar to what will be necessary under the proposal, most do not maintain this data at the level of granularity that will be required to forecast future events. Further, since the proposal precludes the use of static statistical models, it will not be possible for an entity to apply a statistical thought process to its loan portfolio in order to estimate future expected losses. Thus, when an entity reaches a particular point in time (e.g., the end of the month), it must look at its portfolio as it stands at that time and then attempt to determine how its loss-projections will vary in the future.

Unlike the models currently being used by credit unions—particularly smaller credit unions—that involve homogenous loan pools and application of historical loss ratios and environmental loan factors, the models considered in the proposal are much more complex and will therefore require significantly more resources to comply with. This will have a major impact on smaller credit unions in particular that are pressed to meet their internal reporting deadlines under the current credit losses standards.

Another issue of concern, that is also likely to increase the cost of compliance, relates to the audit community. Specifically, it will likely be very challenging for auditors to become comfortable enough with these drastic changes to provide an opinion on the most significant estimate on the balance sheet.

We anticipate an increase in audit fees as a result of the amount of work that will be required for auditors to become comfortable with these changes. In addition, the proposed changes will require credit unions to obtain costly core enhancements. Moreover, we do not believe these added costs will result in a commensurate amount of benefit.

In addition, the proposed CECL model is inconsistent with the accounting principle of matching, which states that expenses should be recorded in the same period as the revenues that relate to those expenses. The proposal is inconsistent since it requires expected future loan losses to be recorded immediately. In addition to its impact on the reporting entity, this inconsistency will likely cause challenges/trepidation within the audit community.

Potential Impact on Consumers, Small Businesses, Communities and the Economy

Credit unions and CUNA are very concerned that the proposal will have a chilling effect on lending in general. Depending on when the final standards are implemented, they could impede the financial recovery and restrict the ability of lenders such as credit unions to meet the credit needs of their communities. This concern reflects the fact that the proposal would require possible losses over the life of a loan to be considered, which could result in creditors overestimating losses and over-reserving their ALLL accounts, at least initially. To avoid the appearance of increasing losses and having to unnecessarily maintain increasing ALLL accounts, creditors may increase their loan standards further and may even be encouraged to do so by examiners. Such a result could dampen lending and discourage creditors from providing loans to borrowers that are even marginally risky.

Another concern is that with the implementation in January 2014 of the “qualified mortgage (QM) standards” under the Consumer Financial Protection Bureau’s “Ability to Repay Rule” (required by the Dodd-Frank Wall Street Reform and Consumer Protection Act), creditors may be very hesitant to make loans to borrowers with debt-to-income (DTI) ratios above 43% (one of the benchmarks for QM). The reluctance to make loans to otherwise creditworthy borrowers who may happen to have a DTI ratio of, say, 45%, could be exacerbated by the FASB proposal if the creditor is concerned about being able to predict accurately the repayment stream over the life of the entire loan that does not conform to QM standards.

The FASB Proposal is Incongruent with IASB Proposal

While the FASB has indicated its intention to achieve a convergence of standards with those of the International Accounting Standards Board (IASB), including on credit losses, it is unclear how this will occur since the IASB's and the FASB's credit losses proposals are very different.

Unlike the FASB proposal, which does not include a trigger for recognizing certain losses, the IASB proposal provides that an entity would only recognize a portion of expected credit losses until a specific recognition trigger has been met. The IASB's credit losses model utilizes the following "two-bucket" approach:

- 12-month expected credit loss (Bucket 1): This category would require a full expected loss recognition only when there is a significant increase in credit risk since a loan was originated or acquired.
- Lifetime expected credit loss (Bucket 2): For all other assets, credit losses would be recorded based on the probability of a default occurring in the next twelve months.

There is concern among some within the accounting industry that the CECL model has the potential of driving U.S. entities to report asset values more conservatively than their international counterparts applying the IASB's proposed credit loss standard.

CUNA's Recommendations to Improve the Proposal

As stated in this letter, CUNA does not believe it would be appropriate to apply the proposed changes to credit unions, based on their distinct structure and purpose as private, not-for-profit, cooperatively owned, financial institutions.

However, if the FASB moves forward with this or a variation of this proposal, it is crucial that the FASB work closely with the federal financial regulatory agencies throughout the remainder of the standard-setting process. We particularly urge collaboration to continue with NCUA in light of the structure of credit unions.

CUNA also urges the FASB to consider a credit impairment approach that is more in-line with the proposed IASB model, particularly the aspect of the IASB's model that uses a twelve-month forecast period. If the FASB moves in this direction, a new proposal should be issued for comments from stakeholders.

Further, there must be an adequate phase-in/transition period for credit unions for any new standards, which should be coordinated with the implementation of the new international standards. CUNA urges the FASB to work with the IASB to delay the effective date of final, consistent credit loss standards for at least three years particularly for non-public reporting entities such as credit unions.

In Sum, CUNA Urges the FASB to Withdraw the Proposal

In closing, the proposal that the FASB has developed has raised a number of concerns within the credit union system, which CUNA has endeavored to address in this letter. Our most fundamental issue is that the proposal attempts to address the problems of a few financial institutions—albeit some extremely large financial institutions that misled or simply did not understand the credit quality of complex investments---by proposing far-reaching changes that will severely impact all financial institutions, including credit unions that did not cause the financial crisis.

We would welcome the opportunity to discuss our concerns with the proposal further. In the meantime, we urge the FASB to consider the impact of its proposed standards on credit unions, their members, and their communities, and to withdraw the current proposal as issued for comments.

Thank you for your attention to our concerns. If you have any questions about our comments, please do not hesitate to contact me or CUNA's Deputy General Counsel Mary Dunn.

Best regards,


Bill Cheney
President & CEO

Cc: All Members of the FASB
Debbie Matz, Chairman, National Credit Union Administration Board
Technical Director, Financial Accounting Standards Board