Financial Accounting Standards Board
801 Main Avenue
Norwalk
CT 06856-5116

International Accounting Standards Board
Columbus Building
7 Westferry Circus
London E14 4HD

August 23, 2023

Financial Instruments – Credit losses

Dear FASB and IASB Board Members,

This comment letter is addressed to the Board Members of both the IASB and FASB. It is a response to the IASB *Request for Information: Post-implementation Review of IFRS 9 Financial Instruments Impairment* and the FASB *Proposed Accounting Standards Update: Financial Instruments – Credit Losses (Topic 326)*.

The accounting for expected credit losses under US GAAP and IFRS presents significant challenges for investors.

- The very different approaches to the accounting for expected credit losses under US GAAP and IFRS reduces international comparability. Furthermore, it is impossible for investors to adjust in order to obtain even approximately comparable balance sheet and profit and loss data.

- The different application of Purchased Credit Deteriorated (PCD) under US GAAP and Purchased Credit Impaired (PCI) under IFRS adds further complexity for investors. Although the result of these two approaches is very similar, the instruments to which the approaches are applied are different; the FASB proposed update will exacerbate this difference.

- The day 2 loss effect results in accounting that does not faithfully reflect the economics of a lending business. Both the US GAAP CECL and the IFRS 3-stage model (although to a lesser extent) result in a misleading day 2 loss which investors find confusing, and which makes it difficult to understand performance metrics. Some companies make non-GAAP adjustments to try to provide investors with more meaningful data, but these do not necessarily solve the problem, and may themselves add to the confusion.

We believe that the current review of both the FASB and the IASB credit loss standards presents a unique opportunity to revisit the potential for convergence in this area and to improve accounting under both US GAAP and IFRS.

The boards worked together over several years to develop a converged solution. Regrettably convergence was not possible at the time, but that may have been primarily due to the unique challenges and different pressures on the boards following the Global Financial Crisis. Circumstances are now different (and the consequence of a non-converged approach perhaps more apparent) such that revisiting the topic jointly may well now achieve a converged solution.

Our preferred converged approach is to apply the existing FASB gross-up method that is used for purchased credit deteriorated assets to all lending. This approach is effectively the same as the method proposed in the 2009 IASB Exposure Draft, which is now used only for purchased credit impaired assets under IFRS 9. When this method was first proposed in the 2009 IASB Exposure Draft, the negative feedback was primarily concern over complexity rather than disagreement with the conceptual basis of the approach. However, at the time, the use of a gross-up approach to simplify the calculation required by the ED was not discussed. Had the gross-up methodology been part of the discussion, stakeholder concern over complexity may well have been satisfactorily addressed.

The other concern regarding the 2009 IASB ED was that, following the financial crisis, there was a perception (particularly amongst banking regulators) that loan loss provisions needed to be higher. While both the IASB 2009 ED approach and the FASB gross-up approach fully provide for all lifetime expected losses, the recognition of the initial ECL as an expense over the life of the instruments arguably meant that the overall result seemed to be less ‘prudent’ than desired.

We think that both the final IASB and FASB standards compromised on the decision-usefulness of the resulting financial statements in favour of achieving an outcome that was deemed to be suitably conservative and would satisfy the banking regulators. This was perhaps understandable following the Global Financial Crisis, but we think, with the benefit of hindsight, this was not the best outcome for investors. If banking regulators believe that the gross up approach is not conservative enough for their unique purposes, they are free to add a suitable overlay, such as eliminating the initial ECL adjustment on the asset side of the gross up for the purpose of setting capital requirements.

The current proposed update to the US GAAP credit loss standard seems to be an acknowledgement that CECL does not work well when there is significant growth in lending, such as following a business combination. However, while the proposed update would bring US GAAP closer to our preferred solution, increasing the use of the gross-up method to all purchased loans simply serves to make the wider problems of CECL more obvious. There is little economic difference between purchasing and originating a loan, and certainly not enough to justify such a very different approach to credit losses.

Response to the FASB Proposed Accounting Standards Update: Financial Instruments – Credit Losses (Topic 326).

We limit our comments to question 2 in the proposed update.

We agree that applying two different impairment models to purchased loans is problematic, produces counterintuitive results, and that the threshold between when each method is applied is arbitrary. However, although US GAAP would seem to be both simplified and improved by applying the proposed update, we believe it will merely move the artificial threshold from one place to another, produce different counterintuitive results, and not ultimately help investors. The current threshold of 'not more / more than insignificant' will be replaced by a 'purchased / originated' divide that is further complicated by an arbitrary concept and definition of "seasoned". The change in threshold simply moves the goal posts and replaces one form of complexity with another. As a result, we do not think overall the update will improve financial reporting to the extent that FASB believes.

Furthermore, the resulting different treatment of originated and purchased loans would likely give rise to artificial 'accounting arbitrage' incentives; for example, swapping loans with an unrelated bank to achieve a different accounting outcome, even though the underlying business is essentially unaffected.

The issue of day 2 CECL losses distorting financial statements in the period of an acquisition, that investors and others have highlighted, applies just as much to other lending. The problem may only become obvious where banks have significant organic growth, but in all cases CECL accounting fails to reflect the economics.

Our recommendation to FASB is to not immediately finalise this update. In the meantime, we suggest that FASB should reconsider the wider use of the CECL approach and take this opportunity to work with the IASB to see whether a converged international solution can now be found to the accounting for credit losses, particularly one based on the existing FASB gross-up method.

Response to the IASB Request for Information: Post-implementation Review of IFRS 9 Financial Instruments Impairment

We limit our comments to questions 1a and 2a in the RFI.

We believe that the issues of timely recognition of credit losses, complexity and providing useful information have only been partially addressed by IFRS 9. The initial 12-month allowance introduces a day 2 loss that does not reflect the economics of lending. Furthermore, the selection of 12-months for measuring that initial allowance and the timing of when loans move to lifetime loss recognition both lack any conceptual foundation.

The fact that the 12-month allowance has resulted in earlier loss recognition than many (but not all) banks experienced under IAS 39, does not mean that investors now receive more useful information. Earlier recognition of losses does not necessarily mean better accounting. Of more importance is that loss allowances faithfully reflect economic losses and are responsive to changes in credit risk. Although the 3-stage model may be more responsive than the IAS 39 incurred loss approach, it is not as responsive as either the PCI / gross-up approach or the US GAAP CECL approach.

IFRS 9 partially solved the complexity caused by multiple impairment approaches under IAS 39. However, complexity remains in IFRS 9 due to the different treatment of purchased credit impaired loans and, even more so, because IFRS is now less converged with US GAAP than it was with IAS 39.

Our recommendation to the IASB is to reconsider the 3-stage approach, and to take this opportunity to work with the FASB to see whether a converged international solution can now be found to the accounting for credit losses, particularly one based on the existing FASB gross-up method.

Yours,

Steve Cooper and Dennis Jullens

The Footnotes Analyst is a blog for investors and analysts on financial reporting and equity analysis that is written by Steve Cooper and Dennis Jullens. Steve Cooper is a former IASB Board Member. Dennis Jullens is an academic and a member of the EFRAG Technical Expert Group. Both Steve and Dennis previously worked in investment banking, including as colleagues at UBS investment research.