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Comment letters - Proposed SOP, Accounting for Discounts Related to Credit Quality

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

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American Institute of
Certified Public
Accountants (AICPA)

Memo

To: AcSEC members and PB6 task force members

From: Brad Davidson, AICPA

CC: Sean Leonard (FASB), Paschal Desroches (SEC), Liz Fender (AICPA)

Date: 05/06/99

Re: Comment letters – Proposed SOP, *Accounting for Discounts Related to Credit Quality*

For your information, comment letters received to date are enclosed.

Regards, Brad

Brad

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Accounting for Discounts Related to Credit Quality

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April 29, 1999

Mr. Brad Davidson
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Dear Mr. Davidson:

On behalf of our members, the American Bankers Association ("ABA") appreciates the opportunity to comment on the Proposed Statement of Position: *Accounting for Discounts Related to Credit Quality* ("proposed SOP") prepared by the Accounting Standards Executive Committee ("AcSEC") of the American Institute of Certified Public Accountants ("AICPA"). The American Bankers Association brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

The ABA does not support AcSEC's proposal to update and elevate the accounting for discounts related to credit quality. The scope of the proposed SOP unnecessarily reaches beyond loans purchased at a discount related to credit quality. The scope of the proposed SOP would encompass all purchased loans, including those acquired in a purchase business combination. The proposed SOP would create a dichotomy in the financial reporting requirements for purchased and originated loans that does not reflect how entities evaluate and manage the risk and return in their loan portfolios. The proposed SOP would create impractical and unrepresentative financial reporting requirements for certain types of purchased loans that would misrepresent the financial impact of lending decisions and credit risk management strategies in financial reports.

The proposed SOP would impose significant implementation burdens that do not reflect how purchased loans are bought, priced, and managed. Many institutions buy portfolios of loans within the context of the expected impact on the overall risk and return profiles in their existing loan portfolios. Institutions allocate allowances for loan losses based on credit risk characteristics that are shared between purchased and originated loans, not based on how loans enter the loan portfolio. However, institutions would have to separate all purchased loans from originated loans and disaggregate all purchased loans into smaller groups to determine whether the proposed SOP applies. If the proposed SOP applies, institutions would be precluded from recognizing a discount related to credit quality as an adjustment of yield, a loss accrual, or valuation allowance for purchased loans. Our concerns about the implementation burden and the relevance of the financial results are compounded for loans acquired in a purchase business combination.

To address our primary concerns, the ABA recommends that AcSEC and the AICPA narrow the scope of the final SOP so that it clearly encompasses only purchased loans that are: a) purchased at a discount related to credit quality; and, b) impaired within the scope of SFAS 114. Thank you for considering the views expressed in this letter and the attachment. The ABA hopes that AcSEC and the AICPA will contact us to discuss any questions or comments they may have about our views.

Sincerely,

Donna Fisher/pd

Donna Fisher
Director of Tax and Accounting

Paul V. Salfi
Senior Financial Policy Analyst

ABA Responses to Questions in Proposed Statement of Position: *Accounting for Discounts Related to Credit Quality*

Issue 1: Like the scope of Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*, the scope set in paragraph 3 of the proposed SOP includes receivables that are loans and debt securities. The scope is grounded in the definition of *loan* in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, qualified to exclude loans measured at fair value if changes in fair value are included in earnings, loans acquired in a business combination accounted for as a pooling of interests, mortgage loans held for sale, leases as defined in FASB Statement No. 13, *Accounting for Leases*, and loans held by liquidating banks. Is this scope appropriate? If not, how should AcSEC amend the scope and why?

No, the scope of the proposed SOP is inappropriate. One of the core problems with the proposed SOP is that its scope goes beyond Practice Bulletin 6: *Amortization of Discounts on Certain Acquired Loans* ("PB 6") and Statement of Financial Accounting Standards No. 114: *Accounting by Creditors for Impairment of a Loan* ("SFAS 114").

Despite its title, the proposed SOP goes beyond PB 6 and applies to all purchased loans, not just those purchased at a discount related to credit quality. In addition, the scope includes loans acquired in a business combination accounted for using the purchase method. Paragraph 3 of the proposed SOP states that the scope applies to all purchased loans (with limited exceptions) for which it is probable that the investor will be unable to collect contractual payments. The proposed SOP does not define a discount related to credit quality nor does it provide guidance on how to delineate between discounts related to changes in credit quality and discounts related to changes in interest rates. In paragraph 1, the proposed SOP also incorrectly assumes that loans are always transferred at less than their contractual payments receivable. Depending on the extent of changes in the interest rate environment, changes in the pricing for credit risk, or perceived future business opportunities, it is possible that loans may be transferred at a price that is more than their contractual payments receivable.

The proposed SOP goes beyond the scope of SFAS 114 in several respects. First, paragraph 6(a) of SFAS 114 contains a scope exclusion for large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. However, this scope exclusion is absent from the proposed SOP. The absence of a scope exclusion for large groups of smaller-balance homogeneous would significantly increase the cost of complying with the proposed SOP and would miscommunicate the impact of portfolio acquisitions on the overall yield and credit risk in loan portfolios. Second, paragraph 8 of SFAS 114 states that the probability of collection is based on "current information and events". However, this scope limitation is absent from paragraph 3 of the proposed SOP.

The scope should be narrowed so it applies only to purchased loans that are: a) purchased at a discount related to credit quality; and, b) impaired within the scope of

SFAS 114. Otherwise, the proposed SOP would impose impractical financial reporting requirements that do not help financial statement users understand the level of credit risk and return in an institution's overall loan portfolio. For example, institutions would have to develop systems that track the nonaccretable difference and accretable yield over the life of these loans. Current loan systems are designed to account for loans according to their contractual terms, not probable cash flows. Furthermore, loan purchases are typically evaluated and managed within the context of their impact on the risk and return in existing portfolios. As a result, there would be little value in forcing institutions to disaggregate all purchased loans and subject them to financial reporting requirements that are less useful and different than those for originated loans. Narrowing the scope as we have proposed would help make the final SOP more practical and relevant.

Issue 2: Paragraph 3 of the proposed SOP implicitly excludes originated loans. AcSEC concluded that the criteria in FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, make it unnecessary to establish other criteria that distinguish between loans originated and loans purchased. Is this appropriate? If not, what criteria should be established?

Yes, this is appropriate.

Issue 3: Paragraph 4 of the proposed SOP would prohibit investors from (a) recognizing – as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk – any of the excess of contractual payments receivable over expected future cash flows (*nonaccretable difference*) or, (b) displaying such excess in the balance sheet. Is this prohibition appropriate? If not, how is an investor justified in recognizing – as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk – losses that were not incurred by the investor?

No. This prohibition is inappropriate for purchased loans that are not impaired under SFAS 114 or for purchased loans that are exempt from SFAS 114, both of which appear to be within the scope of the proposed SOP in paragraph 3. If a purchased loan is not impaired within the scope of SFAS 114, then the investor should recognize the entire discount on the balance sheet. An investor is justified in recognizing the nonaccretable difference as a yield adjustment, loss accrual, or valuation allowance for credit risk if a purchased loan is not impaired under SFAS 114 because a loss may be incurred by the investor that was not incurred by the seller. Furthermore, in many cases it would be difficult to distinguish between losses incurred by the investor and losses incurred by the seller.

We have several objections to the basis for conclusions on this issue in paragraphs B.26 and B.27. We do not believe that these conclusions accurately reflect how loan purchases and business combinations are made, priced, and managed. The basis for conclusions in paragraph B.26 is incorrectly founded on the notion that an investor buys one loan at a time and that the price an investor is willing to pay for a loan solely reflects the investor's estimate of probable credit losses on that loan. Loan purchases are typically made on a portfolio basis, and the price on a purchased loan in the portfolio reflects more than just the investor's estimate of probable credit losses over the life of that loan in the portfolio. The price on a purchased loan in the portfolio reflects the aggregate credit risk in the purchased portfolio, plus factors that might include:

- the current market pricing for similar types of credit risk
- the impact the purchased loans would have on the risk and return in an investor's existing loan portfolio
- future business opportunities with the borrowers
- the seller's need to increase liquidity
- the seller's need to manage credit risk.

The level of correlation between the credit risk in purchased and existing loans will impact the extent of credit risk in investor's overall loan portfolio. Institutions manage the risk of correlation related to credit risk by aggregating purchased and existing loans together into portfolios based on shared credit risk characteristics. Institutions evaluate the shared credit risk characteristics to produce an allowance for loan losses on the entire portfolio of purchased and existing loans. We fail to see the merits in disaggregating loan portfolios and requiring institutions to distinguish between loan valuation allowances made by the seller and those made by the investor for purchased loans that are not impaired.

The basis for conclusions regarding loan pricing and the allocation of allowances for loan losses for credit risk in paragraph B.26 are even more unrealistic in the context of a business combination. In this case, the price paid to acquire an institution is even further removed from the pricing on an individual loan and estimated probable credit losses on that loan. The price paid to acquire an institution reflects the confluence of numerous factors, such as the estimated impact of combining the variables that impact the risk and return characteristics of various lines of business. In a purchase business combination, we do not agree with the statement in paragraph B.27 that it would never be necessary to estimate a loss allowance at acquisition. Furthermore, we do not believe it would be useful to require that investors estimate probable cash flows on individual loans or small groups of loans that are not impaired within the scope of SFAS 114 just because of a purchase business combination. The transfer of loans in a purchase business combination does not in itself render them impaired, and the loans should not automatically be subject to the accounting and disclosure requirements of the proposed SOP.

Issue 4: The proposed SOP would establish the investor's estimate of undiscounted expected future principal and interest cash flows (*expected future cash flows*) as a benchmark for yield and impairment measurements. This approach recognizes that the investor acquired the loan with the expectation that all remaining contractual principal and interest payments would not be received. Accordingly, the approach interprets FASB Statement No. 5, *Accounting for Contingencies*, to focus impairment on whether it is probable that the investor will be unable to *collect all of the investor's originally expected future cash flows* rather than *all amounts due according to the contractual terms of the receivable*. Like FASB Statement No. 114, this approach identifies the yield as the discount rate that equates the present value of expected future cash flows with the purchase price of the loan. Are the expected cash-flows benchmark and the interpretation of FASB Statement No. 5 appropriate? If not, how should yields and impairments be measured and why?

No. The expected cash-flows benchmark and the interpretation of Statement of Financial Accounting Standards No. 5: *Accounting for Contingencies* ("SFAS 5") are inappropriate for a purchased loan that is not impaired. Not all loans are acquired with the expectation that all remaining contractual cash flows would not be received. Contractual cash flows should be the benchmark for measurements of yield and impairment until a purchased loan is impaired. The receipt of contractual cash flows is a more important factor in setting the investor's offering price for unimpaired loans than expected future cash flows, and they should be the basis for the yield and impairment calculations on unimpaired loans. Please also refer to our comments in response to Issue 3 for additional reasons why the proposed interpretation of SFAS 5 is inappropriate for unimpaired loans.

Issue 5: The proposed SOP would preserve Practice Bulletin 6's treatment of positive changes in cash flows after acquisition. Such changes would be recognized prospectively by an increase in yield over the remaining life of the loan. Is this approach appropriate? If not, how should an investor recognize positive changes in cash flows and why?

Yes, this approach is appropriate.

Issue 6: Paragraph 6(b)(2) of the proposed SOP requires that the new, higher yield on a loan (established, for example, by a significant increase in expected future cash flows) must be used as the effective interest rate in any later test for impairment. One practical implication of this provision is that the investor will need to track such changes in yields. Please comment on the appropriateness of this provision.

It would be inappropriate to use the new, higher yield on a purchased loan as the discount rate for an impairment test because it is inconsistent with SFAS 114. SFAS 114 requires that institutions use the original interest rate as the discount rate to isolate the impact of the deterioration in credit quality from the impact of other factors, such as changes in market rates of interest on the present value of expected future cash flows of an impaired loan (see paragraph 51 of SFAS 114). We do not believe that factors other than credit risk should be introduced into a final SOP on the accounting for discounts related to credit quality.

Issue 7: Paragraph 7 of the proposed SOP prohibits investors from accounting for, as new loans, loans within the proposed SOP's scope that are refinanced or restructured after acquisition, other than through a troubled debt restructuring. (Accounting for troubled debt restructurings is already covered by FASB Statement Nos. 15, 114, and 115.) Are the provisions of paragraph 7 appropriate? Why or why not? If not, how should non-troubled refinancings and restructurings be addressed?

Yes, these provisions of paragraph 7 are appropriate.

Issue 8: Paragraph 8 of the proposed SOP allows entities to aggregate loans that have common risk characteristics for purposes of applying paragraphs 4, 5, and 6 of the proposed SOP. AcSEC decided that such common risk characteristics should always include financial-asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans?

No, we do not agree that all of these minimum risk characteristics for the aggregation of loans are always appropriate. While some of the minimum risk characteristics might be appropriate for a particular institution, it would be inappropriate to require that loans should always share all of the minimum risk characteristics before they can be aggregated. The final SOP should not require that institutions always include all of these minimum risk characteristics to aggregate loans, and institutions should have the flexibility to define appropriate risk characteristics.

Strict aggregation criteria would increase the cost of applying the proposed SOP because it might not reflect how an institution manages the credit risk associated with these loans. Furthermore, paragraph 8 of the proposed SOP prohibits combining the excess of contractual payments receivable over the investor's initial investment (whether accretable yield or nonaccretable difference) for a group of loans with a different group of loans. It would also be inappropriate to require that purchase date always be considered (as stated in paragraph B.30). Purchase date is a relatively less important factor in evaluating and managing the credit risk associated with a portfolio of loans. Institutions might aggregate loans that were purchased at different dates if they share similar credit risk characteristics.

The ABA suggests that the application of risk characteristics for the aggregation of loans in the final SOP mirror the application of the risk characteristics for stratifying servicing assets in paragraph 37(g)(1) of Statement of Financial Accounting Standards

No. 125: *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("SFAS 125"). This paragraph in SFAS 125 requires that institutions stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets, but only suggests which risk characteristics institutions might use.

Issue 9: Practice Bulletin 6 addressed whether an investor should accrue income. The proposed SOP eliminates such guidance for loans within its scope because such guidance does not exist for originated loans. Is it appropriate to eliminate the Bulletin's income recognition guidance? If not, what criteria should determine whether the investor should accrue income and why?

Yes, it is appropriate to eliminate the Bulletin's income recognition guidance.

Issue 10: FASB Statement No. 114, as amended, requires disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded. Should the final SOP require such disclosures for loans that are within the scope of this SOP but not within the scope of FASB Statement No. 114?

No. The final SOP should not require such disclosures. The scope of the final SOP should not be broader than SFAS 114.

Issue 11: Disclosure requirements are set out in paragraphs 9 and 10 of the proposed SOP. Are these disclosures appropriate for loans within the scope of the proposed SOP? If not, how should the disclosure requirements be changed and why? Should the final SOP require that accretable yield associated with purchased loans be segregated from that associated with originated loans?

No. The proposed disclosures would be inappropriate for loans within the scope of the proposed SOP because the cost of providing the information would outweigh the benefits to financial statement users. The final SOP should not require that the accretable yield associated with purchased loans be segregated from the accretable yield associated with originated loans. The segregation would not provide financial statement users with better insight into an institution's credit risk profile.

For loans within the scope of the proposed SOP, institutions would have to disclose the following for loans accounted for as debt securities and loans not accounted for as debt securities: a) carrying amount at the beginning and end of the period; b) amount of accretable yield at the beginning and end of the period reconciled for changes; c) amount of nonaccretable difference at the beginning and end of the period reconciled for changes; d) amount of loss accruals and reversals made for loans not accounted for as debt securities during the income statement period presented.

Institutions would incur significant costs to provide the proposed disclosures because they do not mirror the disclosure requirements of SFAS 114 and because institutions do not distinguish between the credit risk associated with originated loans and the credit risk associated with purchased loans. Benefits would be limited because the information does not accurately reflect credit risk management practices and would not help financial statement users efficiently assess the yield and credit risk in an institution's overall loan portfolio. To improve disclosure effectiveness, the scope of the proposed SOP should be narrowed as we have proposed and the disclosure requirements of the final SOP should mirror those in SFAS 114.

Issue 12: The proposed SOP would be effective for financial statements issued for fiscal years beginning after June 15, 2000. Initial application would be required as of the beginning of the investor's fiscal year. Should adoption instead be required as of the end of a fiscal year, without restatement of the results of operations for the preceding twelve months? Why?

The proposed effective date would be unreasonable based on the scope, aggregation criteria, disclosures, and transition provisions of the proposed SOP. Unless these aspects of the proposed SOP are sufficiently modified, we recommend that AcSEC delay the proposed effective date one year so that the final SOP would be effective for financial statements issued for fiscal years beginning after June 15, 2001. It would not be easier for institutions to adopt as of the end of a fiscal year (without restatement of the results of operations for the preceding twelve months) instead of the beginning of the year. Institutions would still have to track changes in various categories throughout the year to satisfy the proposed disclosure requirements.

Issue 13: The proposed SOP would apply to loans acquired before the adoption date, including loans acquired in a purchase business combination, and would require transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would be based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than as of the date the investor acquired the loan. Please comment on the appropriateness of the required transition adjustments. Alternatively, should the proposed SOP not be applied to loans acquired before the adoption date and, if so, why?

The proposed SOP should not be applied to loans acquired before the adoption date because it would require significant systems changes that provide limited benefits. AcSEC has mistakenly concluded in paragraph B.49 that the population of loans affected by the proposed SOP is likely the same as PB 6. The proposed SOP would increase the population of loans on which institutions would have to estimate future cash flows, test impairment, and track the nonaccretable difference and accretable yield in comparison to PB 6.

The scope of the proposed SOP goes beyond PB 6. The proposed SOP would apply to all purchased loans, not just those purchased at a discount related to credit quality. In addition, the proposed SOP would apply to loans acquired in a purchase business combination. On April 21, 1999, the FASB tentatively decided to propose that institutions use the purchase method of accounting for all business combinations initiated after the issuance of a final standard on business combinations (planned for sometime in 2000). Plus, the proposed application of risk characteristics would force institutions to apply the proposed SOP on a disaggregated basis. For these reasons, the population of loans affected by the proposed SOP would be larger than PB 6. Therefore, we recommend that the final SOP only be applied to loans acquired after the adoption date of the final SOP.

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America's
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May 6, 1999

Mr. Brad Davidson
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Re: Proposed Statement of Position on Accounting for Discounts Related to Credit Quality

Dear Mr. Davidson:

America's Community Bankers is pleased to provide comments on certain aspects of the above captioned proposal. ACB is the national trade association for 2,000 savings and community financial institutions and related business firms. The industry has more than $1 trillion in assets, 250,000 employees, and 15,000 offices. ACB members have diverse business strategies based on consumer financial services, housing finance and community development. We appreciate this opportunity to offer our comments on this proposal regarding the acquisition of loans.

In general, ACB does not believe that the proposed SOP should be adopted unless it is modified in several respects.

As discussed in detail below, we believe (a) that the requirements of the proposed SOP will be difficult to implement in computer systems, (b) that the scope of the SOP requires clarification, (c) that the criteria for aggregation of loans is too narrow and (d) that the effective date should not be before January 15, 2001.

Below are comments to specific issues.

Scope

Issue 1:Like the scope of Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans, the scope set in paragraph 3 of the proposed SOP includes receivables that are loans and debt securities. The scope is grounded in the definition of a loan in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan, qualified to exclude loans measured at fair value if changes in fair value are included in earnings, loans acquired in a business combination accounted for as a pooling of interests, mortgage loans held for sale, leases as defined in FASB Statement No. 13, Accounting for Leases, and loans held by liquidating banks. Is the scope appropriate? If not, *how should AcSEC amend the scope and why? (See paragraphs B.4 through B.18 for the Accounting Standards Executive Committee's (AcSEC's) conclusions.)*

Issue 2:Paragraph 3 of the proposed SOP implicitly excludes originated loans. AcSEC concluded that the criteria in FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, make it unnecessary to establish other criteria that distinguish between loans originated and loans purchased. Is this appropriate? If not, what criteria should be established? (See paragraphs B.6 through B.8 for AcSEC's conclusions.)

Issues 1 and 2 are closely related and we will respond to them together. ACB believes that the scope of the SOP should be modified to (a) specifically exclude loans purchased on or near the origination date and (b) exclude all loans held for sale.

The scope of the SOP inappropriately captures indirect loan originations. The definition of a transfer, coupled with the investor's expectation of losses is particularly problematic for subprime loans acquired through indirect means.

Paragraph three states that the SOP "applies to all loans acquired by completion of a transfer and for which it is probable, at acquisition, that the investor will be unable to collect contractual payments receivable..." Investors acquire loans daily from many originators on an indirect basis in the ordinary course of business. The investor will perform due diligence and/or underwriting on individual loans and make its credit decision based on the individual loan.

Arguably, in the case of subprime lending, some losses are probable at the date of acquisition. However, the lender is not able to determine on which loan the losses will be incurred, but instead will price individual subprime loans to take into account the likelihood that the asset-type as a whole will incur losses. The SOP makes no distinction between individual loans and pools of loans and, presumably, applies to both types of purchases.

The premise of the SOP appears to be to isolate, at the date of acquisition, those losses that have occurred from those that will occur. If that is the case, then the scope should be modified to exclude individual loans purchased by the investor on or near the origination date (that is, indirect loan purchases should be treated as if the loans were originated).

The definition of "completion of a transfer" in the Glossary specifically excludes "transactions in which the investor acquires loans from the transferor through an agency relationship, for example, when the transferor bears no risk of loss in making and selling the loans." The presumption that indirect loans already are excluded from the scope of the SOP, because the definition of "completion of a transfer" excludes loans acquired through an agency relationship, may not always hold true. In some instances, that argument will fail because, even though the seller may not be in the business of lending, investors have recourse to the seller and sellers enjoy profit from making loans. That recourse might be limited or full. For example, loans which default in any of the first three payments might be subject to repurchase by the seller. In other cases, any premium paid by the investor at acquisition might be subject to recapture if the loan prepays or charges off at any time during its life. There are many variations of recourse: however, in all cases the transferor is bearing some risk of loss beyond the usual "reps and warranties".

Loans purchased on an indirect basis are very much like originated loans and should be accounted for as such. In that regard, ACB believes that it is inappropriate to distinguish between originated loans and loans purchased on an indirect basis close to the origination date. As of the origination date, the economics for originated loans and loans purchased on or near the origination date are essentially identical -- in neither case does the lender expect individual credits to incur losses, but in both cases the lender knows that losses eventually will be incurred on its portfolio of loans. For accounting purposes, the investor will estimate the amount of cash expected to be received over the life of the loan and accrete or amortize into income the difference between the amount paid to acquire the loan and the amount expected to be received. In fact, when the lender sets pricing for originated loans, it explicitly includes a component for estimated future losses -- that is, both the target and market return on assets for either a single loan or pool of loans includes a loss probability assumption.

Lenders may also purchase loans on a "mini-bulk" basis -- that is, an originator and investor have agreed that instead of transferring loans daily as they are originated, the loans will be transferred monthly or quarterly. These arrangements are a matter of administrative convenience and should not by themselves cause the loans to be included in the scope of the SOP.

It appears that the SOP has been designed primarily to account for bulk acquisitions of loans or acquisition of individual loans that have already incurred some level of impairment. Paragraph B.7 confirms this by indicating that AcSEC believes those loss contingencies related to credit risk should be rare at origination. The application of this SOP to indirect loans acquired on or near the origination date could needlessly and irreparably harm the indirect lending business.

We concur with AcSEC's exclusion of originated loans from the scope of the SOP and, based on the reasons for that exclusion, urge AcSEC also to exclude indirect lending activities from the scope of the SOP. We believe that the scope of the proposed SOP should be clarified to exclude explicitly indirect loans acquired on or near the origination date. There are many ways to accomplish this modification, but perhaps the simplest would be to exclude from the scope loans that are acquired by the investor during the first 90 days after origination or before the borrower makes the first payment, whichever is later.

We also believe that the exclusion from the scope of "mortgage loans held for sale" should be applied to all loans held for sale. Many lenders fund their operations through securitization. As a result, loans are originated or purchased with the intent of securitization and are marked as "held for securitization or sale" on the balance sheet. That characterization in turn leads to accounting for the loans at the lower of cost or market. It will be onerous to apply the requirements of this SOP to loans that will be sold through a securitization a short time after acquisition. Accordingly, we suggest the word "mortgage" be deleted from the exclusion.

Recognition and Measurement

Issue 3: Paragraph 4 of the proposed SOP would prohibit investors from (a) recognizing – as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk – any of the excess of contractual payments receivable over expected future cash flows (nonaccretable difference) or, (b) displaying such excess in the balance sheet. This prohibition applies to all loans within the proposed SOP's scope, including those acquired in a purchase business combination. Is this prohibition appropriate? If not, how is an investor justified in recognizing- as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk- losses that were not incurred by the investor? (See paragraphs B.26 and B.27 for AcSEC's conclusions.)

We agree that any nonaccretable difference related to the acquisition of loans should not be classified as a valuation allowance or accreted to income. It seems appropriate to us that losses incurred prior to the date of acquisition are not relevant to the accounting for purchased loans. We are concerned, however, that the federal financial institution regulators may disagree with that position.

If loans perform exactly as forecasted at acquisition, then the nonaccretable difference will never change. If, however, the performance of a loan or pool of loans is "worse" than believed at acquisition, the regulators will take an "I told you so" approach and begin to require valuation allowances on subsequent purchases of loans. Moreover, regulatory examiners have been trained for years to evaluate loan loss reserves for adequacy. That training is not focused on net carrying amount but rather on whether a valuation allowance exists and whether it is adequate.

We believe that AcSEC should explore this issue with the FFIEC and ask for their views of the proposed accounting. The SEC also is now a major player in setting accounting rules for derivatives. It would be punitive to financial institutions to be caught in a battle between auditors and regulators over whether or not it is appropriate to have valuation allowances on purchased loans at the time of purchase or subsequent to purchase if the loan is performing as expected.

Such a disagreement could lead to expanding the number of differences in GAAP accounting and regulatory accounting rules.

Issue 4: The proposed SOP would establish the investor's estimate of undiscounted expected future principal and interest cash flows (expected future cash flows) as a benchmark for yield and impairment measurements. This approach recognizes that the investor acquired the loan with the expectation that all remaining contractual principal and interest payments would not be received. Accordingly, the approach interprets FASB Statement No. 5, Accounting for Contingencies, to focus impairment on whether it is probable that the investor will be unable to *collect all of the investor's originally expected future cash flows rather than all amounts due according to the contractual terms of the receivable. (See paragraph 5(a) and footnote 5.) Like FASB Statement No. 114, this approach identifies the yield as the discount rate that equates the present value of expected future cash flows with the purchase price of the loan. Are the expected-cash-flows benchmark and the interpretation of FASB Statement No. 5 appropriate? If not, how should yields and impairments be measured and why? (See paragraphs B.33 through B.38 for AcSEC's conclusions.)*

Issue 5: The proposed SOP would preserve Practice Bulletin 6's treatment of positive changes in cash flows after acquisition. Such changes would be recognized prospectively by an increase in yield over the remaining life of the loan (see paragraphs 5(b) and 6(b) of the proposed SOP). Is this approach appropriate? If not, how should an investor recognize positive changes in cash flows and why? (See paragraphs B.39 and B.40 for AcSEC's conclusions.)

Issue 6: Paragraph 6(b)(2) of the proposed SOP requires that the new, higher yield on a loan (established, for example, by a significant increase in expected future cash flows) must be used as the effective interest rate in any later test for impairment. One practical implication of this provision is that the investor will need to track such changes in yields. Please comment on the appropriateness of this provision. (See paragraphs B.39 and B.40 for AcSEC's conclusions.)

Issues 4, 5 and 6 are closely related and we will respond to them together. The approach taken by AcSEC with respect to changes in cash flows is consistent with other GAAP and is reasonable. The foundation is sound -- the initial yield to the investor is based on purchase price and expected cash flows and should be the benchmark for future evaluations for impairment. Increases in cash flows should be recognized immediately, up to the amount of any previous valuation allowance and prospectively thereafter, and decreases in cash flows should be recognized through a valuation allowance. This is consistent with the application of GAAP to premiums paid for many other assets not carried at fair value. We disagree, however, that the benchmark yield should be adjusted in subsequent periods if expected cash flows increase.

The accounting requirements for increased cash flow estimates followed by decreased cash flow estimates seem inconsistent to us. When the increase occurs, the good news is recognized prospectively because that good news is an expectation and not yet a reality. However, if subsequent to that good news the investor receives bad news and expected future cash flows decline, that bad news must be recognized immediately, even if not all of the prior good news was erased. Decreases in cash flow estimates, which follow increases in cash flow estimates, should be recognized in income prospectively. The original yield was determined using a set of assumptions and that set of assumptions has changed. The only appropriate measure is to treat that change as a change in estimate and recognize the impact prospectively.

Consider the following two fact patterns. Assume that a loan is purchased to yield 8%. In one scenario, one year after the purchase the loan is expected to yield 10% for the remainder of its life. The SOP will require that the increase in yield be recognized prospectively. At the end of the second year, the expectation changes again and now the loan is expected to yield 9% for the rest of its life. The SOP would require that a valuation allowance be recorded and that income continue to be booked at 10%. In a second scenario, the expectations for the same loan at the end of year one resulted in a yield of 8½% and at the end of the second year resulted in a yield of 9%. In this case, the two changes in expectation would be accounted for prospectively.

We do not believe that, at the end of two years, these loans should be accounted for differently. Instead, we believe that the yield at acquisition should be the benchmark for future measurements of impairment. Changes in estimates resulting in yields which are greater than the initial benchmark should be handled in the same manner regardless of the order in which they occur. In both of the examples above, the benchmark would be 8%. If estimated future cash flows equate to yields above 8%, all changes should be recognized prospectively. If future cash flows equate to yields below 8%, the amount related to the difference between the current expected yield and 8% should be recognized through a valuation allowance. This would be consistent with the approach of FAS 114 where the benchmark is that an adjustment is required when the expected cash flows are "lower or slower" than the contractual level. Accordingly, we recommend that the last sentence of paragraph 6(b)(2) be changed as indicated below.

"The original ~~resultant~~ yield shall be used as the effective interest rate in any ~~subsequent~~ application of paragraph 6(a) herein."

We are very concerned about the implications the proposed SOP would have on loan servicing systems. Specifically, loan servicing systems would require modification to track the accretable yield and nonaccretable differences as well as the current yield. Any changes in any or all of these items as a result of changes in future expected cash flows must also be tracked in order to maintain an audit trail. These items must be stored in the servicing system at the loan level in order to be meaningful. It is likely that loan servicing systems can be modified to capture and store this information. But such modifications will take time to implement. On the other hand, until the SOP is implemented, the need to store and track this information is not fully known. We therefore believe that a field test might be helpful in determining the level and extent that this information will need to be stored on loan servicing systems. Pending the completion of such a field test, we believe it is premature to gauge whether the requirements of the SOP are reasonable or not.

Issue 7:Paragraph 7 of the proposed SOP prohibits investors from accounting for, as new loans, loans within the proposed SOP's scope that are refinanced or restructured after acquisition, other than through a troubled debt restructuring. (Accounting for troubled debt restructurings is already covered by FASB Statement Nos. 15, 114, and 115.) Are the provisions of paragraph 7 appropriate? Why or why not? If not, how should non-troubled refinancings and restructurings be addressed? (See paragraph B.41 for AcSEC's conclusions.)

The prohibition against new loan accounting for refinancings of non-troubled loans is not appropriate, particularly for individual loans within groups. Loan refinancings are a way of life. Borrowers refinance mortgage loans with increasing frequency and investors take that activity into account when evaluating pools of loans. If actual prepayments differ from anticipated prepayments, appropriate adjustments should be made. One of those adjustments should not be to track subsequent refinancings. How far should that be carried for the borrower who annually refinances a mortgage?

In practice, new loan accounting is required for loan servicing rights. That principle should apply to this SOP as well.

Application to Groups of Loans

Issue 8: Paragraph 8 of the proposed SOP allows entities to aggregate loans that have common risk characteristics for purposes of applying paragraphs 4, 5, and 6 of the proposed SOP. AcSEC decided that such common risk characteristics should always include financial-asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans? (See paragraphs B.30 and B.31 for AcSEC's conclusions.)

Aggregation is a must for purposes of applying this SOP to indirect lending, particularly if AcSEC determines that indirect loans should be included in the scope of the SOP. Moreover, if indirect lending is not excluded from the scope, then the aggregation criteria of "purchase date" and "origination date" will prove to be onerous, burdensome and costly to apply. Consider that indirect lenders purchase loans daily from many different dealers located in various parts of the country. Purchase date aggregation by itself will likely create more than 300 pools each year for active lenders. Multiply that by different interest rates and geographic regions and there could be literally thousands of pools of loans created each year. It appears that indirect lending was not considered when determining the appropriate criteria for aggregation. We strongly urge AcSEC to consider deleting purchase date and origination date from the aggregation criteria.

Aggregation using origination date, interest rate or geographic location will prove to be burdensome for bulk loan purchasers. Today's economy is robust and loan activity occurs at the national level. More and more credit card, mortgage, home equity and other lenders are making, buying, and selling loans nationwide. Many of our members buy pools of loans that have been originated over the course of several months, that have various interest rates, and that have borrowers with addresses in many states. In these cases, we believe the pool should remain intact for purposes of ongoing accounting and evaluation and that the only relevant criterion is purchase date.

Purchase date aggregation will allow investors to estimate future cash flows and evaluate impairment at the pool level. Even though information will need to be tracked at the loan level, the need to evaluate at the pool level is not inconsistent. At acquisition, the investor will make pool level assumptions regarding prepayments, delinquencies and losses. Individual loans within the pool will perform differently over time. It would be onerous and burdensome to split a 1,000 loan pool into 1,000 single loans and record impairment and yield adjustments for each loan individually. We strongly believe that the aggregation criteria not be mandated by the SOP. Investors should be permitted administrative flexibility in determining the appropriate risk characteristic(s) to apply to specific situations.

Issue 9:Practice Bulletin 6 addressed whether an investor should accrue income. The proposed SOP eliminates such guidance for loans within its scope because such guidance does not exist for originated loans. Is it appropriate to eliminate the Bulletin's income recognition guidance? If not, what criteria should determine whether the investor should accrue income and why? (See paragraph B.45 for AcSEC's conclusions.)

Issue 10:FASB Statement No. 114, as amended, requires disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded. Should the final SOP require such disclosures for loans that are within the scope of this SOP but not within the scope of FASB Statement No. 114? (See paragraph B.45 for AcSEC's conclusions.)

Issue 11:Disclosure requirements are set out in paragraphs 9 and 10 of the proposed SOP. Are these disclosures appropriate for loans within the scope of the proposed SOP? If not, how should the disclosure requirements be changed and why? Should the final SOP require that accretable yield associated with purchased loans be segregated from that associated with originated loans? (See paragraphs B.46 and B.47 for AcSEC's conclusions.)

Effective Date and Transition

Issue 12:The proposed SOP would be effective for financial statements issued for fiscal years beginning after June 15, 2000. Initial application would be required as of the beginning of the investor's fiscal year. Should adoption instead be required as of the end of a fiscal year, without restatement of the results of operations for the preceding twelve months? Why? (See paragraphs B.48 through B.50 for AcSEC's conclusions.)

Any implementation date that does not provide sufficient time for modifications to loan servicing and accounting systems will be problematic. Today, most loan servicing systems provide lenders with the capability of entering the amount of discount or premium (whether related to an originated loan under SFAS No. 91 or from an acquisition) into the system. That system then automatically amortizes or accretes that discount or premium to income. The accounting required under the SOP for purchased loans will require that loan servicing systems be altered to accommodate contractual cash flow, expected cash flows, accretable difference, nonaccretable difference and yield at the loan level. Moreover, accommodations will be required to adjust the accretable difference and the nonaccretable difference when the amount of expected cash flows changes and to track the allowance for loan losses at the individual loan level. Although aggregation is permitted, our members have found that unless these types of data are tracked at the loan level, it will be difficult to make the appropriate adjustments when the characteristics of the pools change. For example, the appropriate entries to make when actual losses or prepayments differ from expected losses or prepayments would be easier to determine if the information resides at the loan level. Supplementation of loan servicing systems with subsystems that are external from the vendor-supplied servicing system are problematic -- they require extensive reconciliation to ensure that the two (or more) systems remain in sync.

Although the accounting requirements proposed by this SOP are aligned closely with the requirements of Practice Bulletin 6, the scope of the SOP is broader than that of PB6. Consider that PB6 applies only to loans acquired at a discount from face while the scope of the proposed SOP includes all loans where the investor does not expect to collect all contractual payments whether purchased at a premium or discount. Dependent upon the specific facts and circumstances, an investor may acquire loans where it does not expect to collect all contractual payments and still pay a premium for that loan.[1] Moreover, PB6 relies on the seller's accounting for loans (that is, nonaccrual vs. accrual) in determining whether to accrete discount or not and, in general, purchasers do not buy nonaccrual loans (though some workout and collection specialists do so actively). The net result is that, in practice, very few loans were accounted for on a cost recovery basis and loan servicing systems have not been designed to take into account any portion of the purchase price which should not be accreted to income.

This situation is also complicated by the fact that most lenders and vendors are unwilling to undertake modifications to any system at a time when Y2K remediation and testing is ongoing. Even if Y2K remediation and testing is complete, most firms would prefer to let all systems remain stable and unchanged during the final months of 1999.

We urge AcSEC to consider an extended implementation period for this SOP and believe that it should be effective no earlier than for fiscal years beginning after January 15, 2001. Use of this date will provide investors and service providers with at least one year following the Y2K turnover to appropriately modify their systems.

Issue 13:The proposed SOP would apply to loans acquired before the adoption date, including loans acquired in a purchase business combination, and would require transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would be based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than as of the date the investor acquired the loan. Please comment on the appropriateness of the required transition adjustments. Alternatively, should the proposed SOP not be applied to loans acquired before the adoption date and, if so, why? (See paragraphs B.48 through B.50 for AcSEC's conclusions.)

As discussed above, we believe the scope of the SOP is broader than the scope of PB 6 and will apply to more loans, particularly if indirect loans are not excluded and the aggregation criteria are not modified.

We also believe that the proposed transition could adversely impact regulatory capital levels. Subsequent to purchase, investors may have established valuation allowances for purchased loans. The transition indicated by the SOP will eliminate those valuation allowances and replace them with accretable yield and nonaccretable difference. Under current regulatory

[1] Loans with contractual interest rates that exceed current risk-adjusted market rates will likely trade at premiums to principal.

capital guidelines, certain valuation allowances are treated as Tier 2 regulatory capital. The elimination of valuation allowances will directly impact regulatory capital ratios of financial institutions.

The SOP provides no guidance regarding the method to estimate future cash flows for existing loans. Purchase transactions are conducted at arm's length, but the estimation of future cash flows for loans already owned by the investor is not. Note that the FASB has a Conceptual Framework proposal outstanding on present value and cash flow measurements. Management will need to make judgments regarding expected future cash flows. Application of the SOP to loans acquired before the adoption date is tantamount to asking management to mark such loans to market without looking at market prices.

For these reasons, we believe that this SOP should not be applied to loans acquired before the adoption date.

We appreciate the opportunity to provide our comments and views on these matters. Should you have any questions or wish to discuss our comments in greater detail, please feel free to call me at (202) 857-3131 or e-mail at <cdabroski@acbankers.org>.

Sincerely,

Craig A. Dabroski
Accounting Specialist

AICPA

PCPS

April 29, 1999

Brad Davidson, Technical Manager
Professional Standards and Services
File 2284
American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Re: Exposure Draft of Proposed Statement of Position (SOP), *Accounting for Discounts Related to Credit Quality*

Dear Mr. Davidson:

One of the objectives that the Council of the American Institute of CPAs established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee ("TIC"). This communication is in accordance with that objective.

TIC has reviewed the above referenced exposure draft and is pleased to provide the following comments.

Scope - Paragraph 3

Paragraph 3 of the exposure draft indicates that the proposed SOP applies to all "enterprises." However, the term "enterprises" is not defined. Therefore, during their recent meeting with AcSEC, TIC members noted that given the unique subject matter covered by the proposal, it is not entirely clear whether the SOP will apply to not-for-profit organizations. In response, TIC members were informed that the use of the term "enterprises" was not intended to exclude those organizations.

TIC members recommend that paragraph 3 of the exposure draft be amended to clarify its applicability. This may be accomplished by rephrasing the first sentence in that paragraph to state, "this SOP applies to all entities, including not-for-profit organizations, that acquire loans (*investors*)."

Disclosures - Paragraph 10c

Paragraph 10c of the exposure draft requires an investor to disclose "the amount of nonaccretable difference at the beginning and end of the period, reconciled for additions, sales of loans, reclassifications to or from accretable yield, and eliminating entries during the period."

The members of TIC understand the desire to communicate to financial statement users the "upside potential" inherent in a loan or a group of loans. They question, however, the usefulness of providing all of the information required by paragraph 10c. In this regard, TIC members note that:

- Increases attributable to additions of loans are already reflected in the nonaccretable discount existing at the end of the period.

- The amount of nonaccretable differences attributable to loans sold or paid does not appear to be relevant to the financial statement presentation since the related "upside potential" no longer exists. In addition, this reduction is also reflected in the nonaccretable discount existing at the end of the period.

- Information regarding reclassifications to or from accretable yield is already available from the disclosures required by paragraph 10b.

Based on the above, TIC members believe that a reconciliation between nonaccretable differences existing at the beginning and end of the period is not necessary.

We appreciate the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

James A. Koepke

James A. Koepke, Chair
PCPS Technical Issues Committee

JAK:lec

cc: PCPS Executive and Technical Issues Committees

ARTHUR
ANDERSEN

April 14, 1999

Arthur Andersen LLP

33 West Monroe Street
Chicago IL 60603-5385

Mr. Brad Davidson
Professional Standards and Services
File 2284
American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Dear Mr. Davidson:

We are pleased to comment on the Accounting Standards Executive Committee's (AcSEC's) Proposed Statement of Position, *Accounting for Discounts Related to Credit Quality* (December 30, 1998).

Our concerns about the scope of the final SOP are outlined in the following three comments. Attachment I provides our detailed comments on the proposed SOP. Our responses to the specific questions for comment are provided in Attachment II.

"Agency Relationship" Concept is Undefined and Unnecessary

The last sentence of the proposed glossary's definition of "completion of a transfer" is inoperable and should be deleted. The SOP does not explain what is meant by an "agency relationship" and nothing in AcSEC's basis for conclusions justifies the need for such a distinction. The definition of "completion of a transfer" appropriately includes the words "accounted for as a sale." If AcSEC is concerned that paragraph 9 of Financial Accounting Standards Board (FASB) Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, does not provide an appropriate model for determining when a "purchase" has occurred for the transferee (that is, when a sale has occurred for the transferor), that concern should be taken up with the FASB as part of its project to amend Statement 125. We see no basis for reintroducing a poorly defined "risks and rewards" concept that creates confusion with the control model established by Statement 125.

To the extent AcSEC is concerned that the acquisition is not at arm's length, it should consider that disclosure of that fact already would be required by FASB Statement No. 57, *Related Party Disclosures*.

Scope Should Include Retained Interests

The final SOP's scope should be revised to explicitly include (*a*) loans received as proceeds of and (*b*) loans that are retained interests in transfers of financial assets accounted for as sales under Statement 125. Under Statement 125, the transferor allocates the previous carrying amount of the transferred assets to interests sold and interests retained based on their relative fair values. That could result in a significant difference between a retained interest's carrying amount and its contractual payments receivable. To the extent the transferor will be unable to collect contractual payments receivable due to credit losses, the full difference should not be accreted to interest income.

For example, assume a company originates loans, transfers them in a securitization partially accounted for as a sale, and retains an undivided, subordinated interest in the transferred loans. Because the retained interest has been subordinated, the retained interest's contractual cash flows likely will exceed the retained interest's expected future cash flows. If the retained interest was not subject to the SOP, the entire difference may inappropriately be recognized as accretable yield.

Accordingly, paragraph 3 of the final SOP should be revised as follows (additions are presented in boldface text):

> It applies to all loans (*a*) acquired by completion of a transfer **(including loans an investor, as transferor, receives as proceeds of a transfer or retains as interests in transferred assets)** *and* (*b*) for which it is probable, at acquisition, that the investor will be unable to collect contractual payments receivable…

Similarly, AcSEC should delete the parenthetical "(transferee)" from paragraph 4.

Scope Should Include Lease Receivables

The scope of the final SOP should include sales-type and direct-financing lease receivables acquired by completion of a transfer and for which it is probable, at acquisition, that the investor will be unable to collect contractual payments receivable. Paragraph 68 of FASB Statement No. 98, *Accounting for Leases*, explains that FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, amended paragraph 18(b) of FASB Statement No. 13, *Accounting for Leases*, "to achieve consistency between direct financing leases and loans for the capitalization of origination costs and recognition of income." We see no logical or conceptual reason for excluding sales-type and direct-financing lease receivables from the scope of the final SOP.

If the scope is not changed to include leases, the references to leases in the illustrative examples should be deleted.

*   *   *   *   *

We appreciate the opportunity to comment, and will be pleased to discuss our comments with AcSEC and its staff at their convenience.

Very truly yours,

Arthur Andersen LLP

Attachment I

DETAILED COMMENTS

- AcSEC should work with the FASB staff to ensure that the status section of affected Emerging Issues Task Force (EITF) consensuses ("level C" principles) are appropriately revised concurrent with issuance of the final SOP ("level B" principles).

- For clarity, insert the words "that do not meet the definition of debt security" after the words "Certain loans" in footnote 2.

- Append the following to paragraph 3(a) to reflect the effects of Statement 134:

  > "and FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise.*[fn]
  >
  > [fn]Paragraph 6 of FASB Statement No. 65, as amended by FASB Statement No. 134, requires that a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process."

- For clarity, insert the words "paragraph 4 of" before "FASB Statement No. 65" in paragraph 3(b). Also, insert the words ", as amended" after the title of Statement 65 in paragraph 3(b).

- Append the following to paragraph 3 to reflect the effects of Statement 133:

  > "This SOP does not apply to loans that are subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.* If a loan would otherwise be in the scope of this SOP and it has within it an embedded derivative that is subject to FASB Statement No. 133, the host instrument (as described in Statement 133) remains within the scope of this SOP. "

- EITF Issue 93-18, *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate,* and EITF Issue 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate,* address the impact of prepayments on the accounting for loans within their scope. AcSEC should address the effects of the final SOP on EITF Issues 93-18 and 89-4. For example, does the final SOP effectively nullify EITF Issue 89-4 for loans within the scope of the final SOP? Or should some other approach be applied that reconciles the differing approaches to cash flow estimates for loans within the scope of both the SOP and EITF Issue 89-4?

- Paragraphs 5(a) and 6(a) of the proposed SOP establish the investor's estimate of expected future cash flows as the benchmark for impairment measurements. As a practical expedient, paragraph 13 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* allows a creditor to measure impairment based on a loan's observable market price or the fair value of the collateral if the loan is collateral dependent. The basis for conclusions of the final SOP should observe that use of the practical expedients permitted by Statement 114 to measure impairment for loans within the scope of the SOP is inconsistent with the SOP's expected-future-cash-flows approach to impairment measurement and recognition of interest income. Only if recognition of interest income on a loan accounted for under the SOP is suspended should the creditor measure impairment in a manner not based on expected future cash flows.

Recognition of income on a loan under the SOP is dependent on having a reasonable expectation about the timing and amount of cash flows. If the creditor is not using expected future cash flows to measure impairment of a loan because the timing of either a sale of the loan into the secondary market or a sale of loan collateral is indeterminate, the creditor should not be recognizing income on the loan. Alternatively, if the expected timing and amount of cash flows from such sales are reasonably estimable, they should be used to both measure impairment and recognize income.

The basis for conclusions in the final SOP also should observe that, if a creditor determines that foreclosure is probable, paragraph 13 of Statement 114 requires that the creditor measure impairment of the loan based on the fair value of the collateral. In that circumstance, the loan's expected future cash flows presumably would include the fair value of the collateral less estimated selling costs.

- The final SOP should address the accounting to be applied in circumstances in which a loan must be removed from a group of loans that have been aggregated for the purpose of applying the SOP. For example, the investor may foreclose on a loan or otherwise receive assets in satisfaction of the loan. In that circumstance, we believe the loan should be removed from the group at its carrying amount. Specifically, the difference between the loan's carrying amount and the fair value of the collateral or other assets received should not affect the calculation of accretable yield for the group of loans from which it was removed.

- Insert the words "Upon initial application of this SOP," at the beginning of paragraph 12.

- Append the following footnote to paragraph A-9:

  > "[fn]This SOP does not address when an investor should record a direct write-down of an impaired loan."

  Further, the term "charge-off" has been used in some paragraphs and the term "write-down" in others. We suggest one or the other be selected and used consistently.

- Presumably, the quantitative information in paragraph A-19 relates to Company A. The illustrative loan (in paragraphs A-2 and following) was for $4 million. Accordingly, the words "Dollars in Thousands" should be added to the tables in paragraph A-19 or the figures should otherwise be amended to improve the consistency of presentation.

- In paragraph A-19, the words "amortized cost" should be changed to "carrying amounts." We do not understand the use of the term "amortized cost" for available-for-sale securities.

- In paragraph B-5, insert the words "discussed in paragraph 4 of" after "face amount concept."

- Add the following footnote after item (*c*) in paragraph B-6:

  "fnEITF Issue No. 87-17, *Spinoffs or Other Distributions of Loans Receivable to Shareholders,* requires that such loans (received as dividends-in-kind) initially be measured at fair value. This SOP provides additional guidance on recognition, measurement (including subsequent measurement), and display of such loans."

- In paragraph B-32, insert the words "accretable yield or" after the word "displaying".

- In the glossary, amend the definition of common risk characteristics as follows (additions are presented in boldface text; deletions are presented in strikethrough text):

  "Common risk characteristics. For purposes of applying paragraph 6 of this SOP, common risk characteristics shall include, at a minimum, **all of the following:** financial asset type, ~~purchase date,~~ interest rate, date of origination, term, geographic location, and credit risk."

  (Given the other criteria, we do not understand why purchase date is relevant incrementally.)

- In the glossary, append the following to the definition of "contractual payments receivable":

  "(For retained interests in transferred financial assets, "contractual terms" are the terms of the financial assets underlying the retained interest rather than those of the retained interest itself.)"

# # #

Attachment II

SPECIFIC QUESTIONS FOR COMMENT

Scope

Issue 1: **Is the scope appropriate? If not, how should AcSEC amend the scope and why?**

Issue 2: **[Paragraph 3 of the proposed SOP's scope relies on Statement 125.] Is this appropriate? If not, what criteria should be established?**

The scope of the proposed SOP is not entirely appropriate. The scope of the final SOP should also include sales-type and direct financing leases, retained interests in transferred financial assets, and should not introduce a concept of "agency relationships." (See our primary comments.)

Recognition and Measurement

Issue 3: **[Are the prohibitions in paragraph 4] appropriate? If not, how is an investor justified in recognizing—as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk—losses that were not incurred by the investor?**

For the reasons set forth in the basis for conclusions, paragraph 4 is appropriate as written.

Issue 4: **Are the expected-[future-]cash-flows benchmark and the interpretation of FASB Statement No. 5 appropriate? If not, how should yields and impairments be measured and why?**

The expected-cash-flows benchmark and the interpretation of FASB Statement No. 5, *Accounting for Contingencies*, are appropriate for the reasons set forth in the basis for conclusions.

Issue 5: **Is [the preservation of Practice Bulletin 6's treatment of positive changes in cash flows after acquisition] appropriate? If not, how should an investor recognize positive changes in cash flows and why?**

The proposed treatment of positive changes in cash flows after acquisition is appropriate for the reasons set forth in the basis for conclusions.

Issue 6: **Please comment on the appropriateness of [paragraph 6(b)(2)].**

The new, higher yield on a loan should be used as the effective interest rate in any later test for impairment for the reasons set forth in the basis for conclusions.

Issue 7: **Are the provisions of paragraph 7 appropriate? Why or why not? If not, how should non-troubled refinancings and restructurings be addressed?**

The provisions of paragraph 7 are appropriate for the reasons set forth in the basis for conclusions.

Application to Groups of Loans

Issue 8: **Are [the] minimum risk characteristics [for aggregation as set forth in paragraph 8] appropriate? If not, what criteria should govern aggregation of loans?**

The criteria in paragraph 8 are appropriate for the reasons set forth in the basis for conclusions.

Income Recognition

Issue 9: **Is it appropriate to eliminate [Practice Bulletin 6's] income recognition guidance? If not, what criteria should determine whether the investor should accrue income and why?**

The elimination of the income recognition guidance is appropriate for the reasons set forth in the basis for conclusions.

Issue 10: **Should the final SOP require [disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded] for loans that are within the scope of this SOP but not within the scope of FASB Statement No. 114?**

No. A company's accounting policy disclosures will need to address the application of the final SOP, which should be sufficient.

Disclosures

Issue 11: **Are [the disclosure requirements set out in paragraphs 9 and 10 of the proposed SOP] appropriate for loans within the scope of the proposed SOP? If not, how should the disclosure requirements be changed and why?**

Yes. The disclosure requirements are appropriate for the reasons set forth in the basis for conclusions.

Should the final SOP require that accretable yield associated with purchased loans be segregated from that associated with originated loans?

We are confused by the question. We understand the SOP to already require that accretable yield cannot be displayed on the face of the balance sheet and that disclosures about changes in the balance of accretable yield are limited to loans within the scope of the SOP.

Effective Date and Transition

Issue 12: **Should [initial] adoption [of the final SOP] be required as of the end of a fiscal year, without restatement of the results of operations for the preceding twelve months? Why?**

No. We support the proposed transition provisions for the reasons set forth in the basis for conclusions.

Issue 13: **Please comment on the appropriateness of the required transition adjustments [for loans acquired before the adoption date]. Alternatively, should the proposed SOP not be applied to loans acquired before the adoption date and, if so, why?**

We support the proposed transition adjustments for loans acquired before the adoption date for the reasons set forth in the basis for conclusions.

AIMR

ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH

May 10, 1999

Mr. Brad Davidson
Technical Manager
Professional Standards and Services; File 2284
American Institute of Certified Public Accountants
1455 Pennsylvania Ave., NW
Washington, D.C. 20004-1081

Re: Exposure Draft – Proposed Statement of Position: *Accounting for Discounts Related to Credit Quality*

Dear Mr. Davidson:

The Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR)[1] is pleased to comment on the Accounting Standards Executive Committee's (AcSEC) proposed Statement of Position (SOP) on accounting for discounts related to credit quality. The FAPC is a standing committee of AIMR, charged with maintaining liaison with and responding to the initiatives of bodies which set financial accounting standards and regulate financial statement disclosures. The FAPC also maintains contact with professional, academic, and other organizations interested in financial reporting.

General Comments

Overall, we agree with AcSEC's proposed accounting and disclosure requirements for discounts related to credit quality on loans and debt securities. In particular, we would like to emphasize the need for transparent and consistent information relating to changes in the estimates and assumptions that are used for recalculating the accretable yield and determining impairments. We recommend that a schedule be required for each reporting period, which displays comparable data for the beginning and ending balances of loans and debt securities, the accretable yield, and the nonaccretable difference.

The FAPC has traditionally supported a single effective date for adoption. That position applies in this case as well. The effective date should be implemented as soon as it is feasible after the accounting policy is promulgated and a final statement is released in order to promote comparability of different enterprises' financial statements. For this SOP, we strongly support adoption at the beginning of the fiscal year.

[1] The Association for Investment Management and Research is a global, nonprofit organization of more than 33,000 investment professionals from 70 countries worldwide. Through its headquarters in Charlottesville, Virginia, and more than 80 affiliated societies and chapters throughout the world, AIMR provides global leadership in investment education, professional standards, and advocacy programs.

Issue 1: Scope of the Statement of Position
Is the scope appropriate? If not, how should AcSEC amend the scope and why?

The FAPC believes that the scope of the SOP is appropriate for an AcSEC document. The primary purpose of this SOP is to provide accounting treatment for purchased loans and changes to the carrying values of those loans due to changes in credit quality. Therefore, it may be viewed more as an application, rather than an extension, of GAAP.

With respect to the specific instruments to be covered by the SOP, we concur with the exclusion of loans carried in the balance sheet at fair value if the changes in fair value are taken to the income statement in the current period. If loans are marked to market with changes in fair value reported on the income statement in the current period, then the issues addressed by this standard are rendered moot. We also concur with the exclusion of loans acquired in a business combination that is accounted for as a pooling-of-interests because such exclusion is consistent with our understanding of the theory underlying the pooling-of-interests' exception to accounting for business combinations. With respect to mortgage loans held for resale, we recognize that SFAS No. 65 prohibits the accretion of the discount on such loans and that AcSEC cannot override a provision in an FASB pronouncement. We do not have sufficient experience with loans held by liquidating banks and, therefore, do not have an opinion regarding their exclusion from the scope of the SOP. Finally, we concur with the exclusion of finance leases since they have not been included in previous accounting standards covering the treatment of financial instruments. We believe inclusion of these leases would be creating new accounting principles for finance leases and, therefore, would be outside the scope of this SOP.

Issue 2: Exclusion of Originated Loans
Is this exclusion appropriate? If not, what criteria should be established?

We concur with excluding originated loans from the SOP's scope because such loans and any related discounts are already addressed in FASB Statement No. 91. We agree with the reasoning in the SOP that loss contingencies due to credit risk on these loans should be extremely rare.

Issue 3: Prohibit the Recognition of Loss Accrual or Valuation Allowance
Is this prohibition appropriate? If not, how is an investor justified in recognizing – as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk – losses that were not incurred by the investors?

We agree with prohibiting the recognition of the nonaccretable difference as a loss accrual or a valuation allowance. Furthermore, we strongly recommend that adequate disclosures be required since the nonaccretable difference will not be displayed on the balance sheet. At a minimum, adequate disclosures should include:

1. the assumptions used in revaluing the loans, the amount of the revaluation and the reason the enterprise adjusted the expected future cash flows; and

2. a comparison of actual contractual cash flows to expected cash flows as expectations change (either up or down, or both) for the periods reported in the financial statements.

Issue 4: Measurement of Yields and Impairments

Are the expected-cash-flows benchmark and the interpretation of FASB Statement No. 5 appropriate? If not, how should yields and impairments be measured and why?

We agree with the use of expected future cash flows as the benchmark for yield and impairment measurements because it is consistent with other accounting standards (FASB Statements No. 5 and No. 114). This benchmark recognizes that purchased loans are priced with the expectation that not all of the remaining contractual principal and interest payments are ultimately received given the credit risk associated with the loans.

Issue 5: Treatment of Positive Changes in Cash Flows after Acquisition

Is the prospective recognition of positive changes in cash flow as an increase in yield over the remaining life of the loan appropriate? If not, how should an investor recognize positive changes in cash flows and why?

We prefer immediate rather than prospective recognition since the former is more consistent with fair value measurement. However, given the pending completion of the FASB's project on fair value reporting for all financial instruments, we believe prospective recognition is appropriate for an AcSEC position under its current guidelines for developing new accounting policies.

Issue 6: Use of Effective Interest Rate for Impairment Test

Is it appropriate to use a new, higher yield on a loan as the effective interest rate in any later test of impairment?

We support the use of the adjusted yield, which results from recalculating the accretable yield for the purchased loans, in determining any future loan impairments. The adjusted yield, rather than the original yield used to calculate the nonaccretable difference and accretable yield at the time the loan was purchased, better reflects the current credit risk and value of the loan.

Issue 7: Accounting for Refinanced and Restructured Loans after Acquisition

Is this provision (Paragraph 7) appropriate? Why or why not? If not, how should non-troubled refinancing and restructuring of loans be addressed?

We agree that refinanced or restructured loans, which are not the result of troubled debt restructurings, should not be considered new loans. This provision is necessary because, in its absence, an enterprise would be able to recognize a gain or loss in the current period which is material enough to disclose and, therefore, transparent to the financial statement user. However, the reversal of the gain or loss could occur over several future periods. Such a reversal may not be transparent to the financial statement user if its impact is relatively immaterial and, hence, does not merit full disclosure. Furthermore, we believe that loan data would not be comparable among enterprises if such transactions were recorded as new loans.

Issue 8: Aggregating Loans with Common Risk Characteristics
Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans?

The FAPC believes that the theoretically correct application of the guidance for this SOP would be on a loan-by-loan basis. However, aggregating loans with similar characteristics would be acceptable to us as a cost-benefit tradeoff. If loans are aggregated, we believe that duration should also be included in the list of risk characteristics used. Duration considers both the yield and expected cash flows of the loan and is a common measurement of risk used in determining the value or price of fixed income instruments. The supplemental disclosures should describe the basis for any aggregation (i.e., which common risk characteristics were considered and used) and the reasons underlying their ultimate selection.

Issue 9: Elimination of Practice Bulletin 6 Guidance on Accrued Income
Is it appropriate to eliminate the Bulletin's income recognition guidance? It not, what criteria should determine whether the investor should accrue income and why?

We have no position on this issue because we are not sufficiently familiar with the content of this practice bulletin.

Issue 10: Recognizing Interest Income on Impaired Loans
Should the final SOP require disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded, for loans within the scope of the SOP but not within the scope of FASB Statement No. 114?

We strongly support the disclosure of the enterprise's policy for recognizing interest income, as well as how cash receipts are recorded, on impaired loans. Users of financial statements need this information to assist in forecasting both earnings and cash flows, which are then used in the overall assessment of an enterprise's financial position and value.

Issue 11: Disclosure Requirements
Are the disclosure requirements appropriate for loans within the scope of the proposed SOP? If not, how should the disclosure requirements be changed and why? Should the final SOP require that accretable yield associated with purchased loans be segregated from that associated with originated loans?

We strongly support the proposed requirement to disclose the carrying amounts of loans at the beginning and end of the period along with the accretable yield and nonaccretable difference, reconciled for additions, accretion, sales of loans and reclassifications to or from the nonaccretable difference during the period. The preferred disclosure format would be a schedule with a reconciliation of these items for each period that an income statement is provided. Such a format facilitates the extraction of financial data. Users of financial statements need this detailed information to evaluate how changes in credit quality impact expected cash flows; it also facilitates more accurate cash flow forecasts. Cash flow analyses are essential to investors because they are used in determining and assessing an enterprise's overall value and for making informed investment decisions.

Issue 12: Initial Application Would Be as of the Beginning of the Investor's Fiscal Year
Should adoption instead be required as of the end of a fiscal year, without restatement of the results of operations for the preceding twelve months? Why?

We prefer that adoption be required at the beginning of the fiscal year because interim reports would provide information with better predictive quality than if the information was only required in year-end reports. Adoption at the beginning of the fiscal year and disclosure of information during the year would eliminate the year-end "surprise" often caused by a change in accounting treatment.

Issue 13: Application of SOP to Loans Acquired before the Adoption Date
Are the required transition adjustments appropriate? Should the proposed SOP not be applied to loans acquired before the adoption date and if so, why?

We believe that the transition adjustments are appropriate as proposed. The current values of the purchased loans would provide users of the financial statements with valuable information that is comparable and facilitates the evaluation of these loans and the effects of changes in credit quality.

Concluding Remarks

The Financial Accounting Policy Committee appreciates the opportunity to comment on AcSEC's proposal on accounting for discounts related to credit quality on certain loans and debt securities. If any of the members of AcSEC, its Discount Accretion Task Force, or AICPA staff have questions or seek amplification of our views, we would be pleased to answer any questions or provide additional information you might request.

Respectfully yours,

Gabrielle Napolitano

Gabrielle Napolitano, CFA
Chair
Financial Accounting Policy Committee

Patricia D. McQueen

Patricia D. McQueen, CFA
Vice President, Advocacy,
Financial Reporting & Disclosure

cc: AIMR Advocacy Distribution List
Michael S. Caccese, Senior Vice President, General Counsel & Secretary, AIMR
Georgene B. Palacky, CPA, Director, Advocacy Financial Reporting & Disclosure, AIMR

BANK ONE.

April 29, 1999

Mr. Brad Davidson
Technical Manager Professional Standards and Services, File 2284
American Institute of Certified Professional Accountants
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081
E-mail: bdavidson@aicpa.org

Subject: Invitation to comment on *Proposed Statement of Position, Accounting for Discounts Related to Credit Quality*, dated December 30, 1998.

Dear Mr. Davidson,

This letter is submitted by BANK ONE CORPORATION, with assets of $261.5 billion at December 31, 1998, in response to the invitation to comment on the Exposure Draft Proposed Statement of Position, *Accounting for Discounts Related to Credit Quality* ("the Exposure Draft").

We appreciate the opportunity to submit comments and understand that AcSEC undertook this project to identify those objectives of Practice Bulletin 6 that continue to be relevant, as well as to update and elevate the authority of related guidance. However, we believe the Exposure Draft improperly applies the concept of FASB Statement No. 114 to pools of smaller-balance homogeneous loans, departs from FASB Statement No. 5, and possibly amends APBO #16, among numerous other issues. Furthermore, the Exposure Draft appears to go beyond Practice Bulletin 6 by including all purchased loans for which it is probable that an investor will be unable to collect all contractual payments, rather than loans purchased at a discount relative to credit quality. Aside from the conceptual inconsistencies, it proposes an accounting methodology which is impossible to implement for revolving consumer credit accounts.

We believe the Exposure Draft's approach can work well to provide guidance on the accounting for individual purchased loans which are evaluated individually for their collectibility, similar to FASB Statement #114. It becomes fatally flawed in dealing with portfolios when it implies, indeed, proscribes that no other allowance for credit losses applies to a portfolio of FASB Statement #114 and other loans acquired in a business combination. For these portfolios, the FASB Statement #5 concept of losses inherent in the portfolio produces loss amounts greater than the amounts produced by the sum of reserves for individually impaired loans under FASB Statement #114. This additional allowance (reserve) was acknowledged as necessary by FASB during its FASB Statement

#114 deliberations and by the SEC in its 1998 Joint Release with the bank regulatory agencies. To imply that the "only" reserve necessary is the "nonacccretible discount" is in direct conflict with these important precedents, and does not represent an acceptable standard operating approach.

Given these issues, we believe the Exposure Draft promulgates accounting guidance that is in conflict with current accounting literature and goes beyond that which AcSEC has been empowered to accomplish. Therefore, we believe this Exposure Draft should be significantly altered or abandoned and that the FASB should address how to update the concepts of Practice Bulletin 6 as part of its business combinations and fair value of financial instruments project. Alternatively, AcSEC could delete the outdated concepts of Practice Bulletin 6, as it is unclear from our experience that a significant need for updated guidance exists in current practice.

The approach outlined by the Exposure Draft is in sharp contrast to the application of FASB Statements 5 and 114. The FASB considered these issues throughout deliberations of the concepts of accounting by creditors for the impairment of a loan, and concluded that FASB 114 should not apply to pools of smaller-balance homogeneous loans that are collectively evaluated for impairment. A recent article dated April 12, 1999, by Sean Leonard, Tim Lucas, and Leslie Seidman, "*Application of FASB Statements 5 and 114 to a Loan Portfolio*," further supports the Board's conclusion.

The exclusion of pools of smaller-balance homogeneous loans from the scope of the Exposure Draft would solve most of the concerns noted above. However, it would likely lead to the issuance of a Statement of Position (SOP) with little value, in that a substantial portion of the loans purchased in the market place are pools of smaller-balance homogeneous loans.

We are also concerned that the scope of the Exposure Draft is not clearly defined. We would normally conclude that the SOP would apply to purchases of individual "troubled or "impaired" loans, but paragraph 3 of the Exposure Draft refers to "...all loans...for which it is probable...that the investor will be unable to collect contractual payments receivable.". If the scope the Exposure Draft was intended to go beyond applicability to "troubled" or "impaired" loans, we believe this would result in a significant difference between the accounting for originated and purchased loans and would detract from the comparability of accounting and financial reporting. If AcSEC proceeds with the Exposure Draft, we would strongly recommend that it limit its applicability to purchases of individual "troubled" or "impaired" loans. While developing the definition of "troubled" loans may be difficult, the concept does exist in the application of FASB Statements #15 and #114.

Another concern, should AcSEC determine to proceed with the Exposure Draft, relates to the onerous record keeping that would result from the application to pools of smaller-balance homogeneous loans. Current systems cannot accommodate tracking contractual principal, interest, total contractual payments, yield discounts, credit quality discounts, accretion of yield discounts, losses related to credit quality discounts, additional allowances for credit losses, losses related to allowances for credit losses, and recoveries related to losses previously recognized. Further, the reconciliation of all such balances to the outstanding contractual principal would be next to impossible. The sheer number of all such balances for individual loans and groups of loans, disaggregated based on common risk characteristics, would be overwhelming. If the conceptual reasons were not compelling enough to warrant the exclusion of pools of smaller-balance homogeneous loans, the burdensome record keeping requirements would be. Development of required systems would not be practicable nor cost effective.

In addition, examples of how the requirements would be applied to the purchase of pools of revolving loans will need to be developed in the event that AcSEC determines to proceed with the Exposure Draft. We believe that, in addition to the record keeping problems noted above, the application of the concepts in the Exposure Draft to such loans would require the use of numerous assumptions that would trigger further complications and problems that would in the end make this Exposure Draft impossible to implement.

Finally, our APBO #16 concern is AcSEC's selective reading of paragraph 88b of this accounting standard. While relying on the first part of the sentence, "present values of amounts to be received determined at appropriate interest rates," to justify its position on no allowance for credit losses beyond nonaccretable discount, it ignores the balance of the sentence which provides a "reduction for allowances for uncollectibility and collection costs."

We can only conclude from reading the entire sentence that accounting standards require the recording of an allowance for credit losses beyond the present value concepts proposed in this Exposure Draft. If AcSEC truly believes that the allowance for credit losses should not be recorded in a purchase business combination, then it should promote the amendment of APBO #16 as part of the Board's business combinations project, not as part of this Exposure Draft.

In summary, the Exposure Draft improperly applies FASB Statement 114 to portfolios of smaller balance homogeneous loans, departs from FASB Statement #5, and inexplicably appears to amend APBO #16. If AcSEC proceeds, it should limit the scope of this Exposure Draft to the purchase of individual "troubled" or "impaired" loans. However, such a limited scope would produce an SOP with little value. Therefore, we recommend that this Exposure Draft be abandoned or significantly altered, and that the FASB address how to update the concepts of Practice Bulletin 6 as part of both its business combinations and fair value of financial instruments projects. Alternatively, AcSEC could simply delete the outdated concepts of Practice Bulletin 6, as a significant need for updated guidance for the remaining concepts of Practice Bulletin 6 may not be necessary.

Detailed responses to the specific issues outlined in the Exposure Draft are included in the attached Exhibit. We appreciate your consideration of our views and would be glad to discuss our comments with you.

Sincerely,

William J Roberts

William J. Roberts
Senior Vice President/Controller
BANK ONE CORPORATION

Attachment

Exhibit

Issue 1: **Like the scope of Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*, the scope set in paragraph 3 of the proposed SOP includes receivables that are loans and debt securities. The scope is grounded in the definition of *loan* in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, qualified to exclude loans measured at fair value if changes in fair value are included in earnings, loans acquired in a business combination accounted for as a pooling of interests, mortgage loans held for sale, leases as defined in FASB Statement No. 13, *Accounting for Leases,* and loans held by liquidating banks. Is the scope appropriate? If not, how should AcSEC amend the scope and why? (See paragraphs B.4 through B.18 for the Accounting Standards Executive Committee's (AcSEC's) conclusions.)**

We do not believe that the scope of the Exposure Draft is appropriate. It appears to be too broad in that it exceeds the original scope of Practice Bulletin 6 and FASB 114. The scope of FASB Statement #114 excludes pools of smaller-balance homogenous loans that are collectively evaluated for impairment. This exclusion was primarily due to it being impracticable to apply the provisions of FASB 114 to these types of loans. In addition, the Exposure Draft states that AcSEC's intent for the scope was to be grounded in the definition of a loan in FASB Statement #114. While this definition may have been used in determining the scope, we find it unacceptable that AcSEC has expanded the scope of the Exposure Draft beyond loans covered under FASB Statement #114.

The scope of the Exposure Draft includes all purchased loans, even when those loans were not purchased at a discount due to credit quality. We would surmise that the original scope of the Exposure Draft (based on the title of the Exposure Draft) was intended to only cover loans that were purchased at a discount due to credit quality. However, in response to concerns raised during the deliberation and drafting stages prior to the issuance of the Exposure Draft, we believe that the scope has been inappropriately broadened to include all purchased loans for which it is probable that the investor will be unable to collect all contractual payments. As such, the scope of the Exposure Draft should be narrowed to include only those loans that are purchased at a discount due to credit quality and that are impaired under FASB Statement #114.

Issue 2: **Paragraph 3 of the proposed SOP implicitly excludes originated loans. AcSEC concluded that the criteria in FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, make it unnecessary to establish other criteria that distinguish between loans originated and loans purchased. Is this appropriate? If not, what criteria should be established? (See paragraphs B.6 through B.8 for AcSEC's conclusions.)**

Exhibit

Yes. The guidance included in FASB Statement #125 is adequate to distinguish between loans originated and loans purchased.

Issue 3: **Paragraph 4 of the proposed SOP would prohibit investors from (*a*) recognizing—as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk—any of the excess of contractual payments receivable over expected future cash flows (*nonaccretable difference*) or, (*b*) displaying such excess in the balance sheet. This prohibition applies to all loans within the proposed SOP's scope, including those acquired in a purchase business combination. Is this prohibition appropriate? If not, how is an investor justified in recognizing—as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk—losses that were not incurred by the investor? (See paragraphs B.26 and B.27 for AcSEC's conclusions.)**

No. We strongly disagree with the assertion that all inherent losses can be attributable or tied to individual loan cash flows. This is particularly true for a purchase of any loan portfolio, particularly in the case of those loans acquired in a purchase business combination. There has been much debate on this topic; however, it has been acknowledged by the FASB during its FASB Statement #114 deliberations and by the SEC in its joint release with the bank regulators that an allowance beyond that mandated by FASB Statement #114 is required. We believe this an appropriate finding and makes the SOP unworkable except in the case of individually purchased loans.

We would also suggest that a "nonaccretable" discount looks, walks and talks like an allowance for credit losses – so why not reflect it as such in the financial statements? It is the only workable solution that appropriately reflects net loans in the financial statements, provides for consistency in financial reporting, and minimizes the cost/processes associated with loan portfolio purchases.

Issue 4: **The proposed SOP would establish the investor's estimate of undiscounted expected future principal and interest cash flows (*expected future cash flows*) as a benchmark for yield and impairment measurements. This approach recognizes that the investor acquired the loan with the expectation that all remaining contractual principal and interest payments would not be received. Accordingly, the approach interprets FASB Statement No. 5, *Accounting for Contingencies*, to focus impairment on whether it is probable that the investor will be unable to *collect all of the investor's originally expected future cash flows* rather than *all amounts due according to the contractual terms of the receivable*. (See paragraph 5(a) and footnote 5.) Like FASB Statement No. 114, this approach identifies the yield as the discount rate that equates the present value of expected future cash flows with the purchase price of the loan. Are the expected-cash-flows benchmark and the interpretation of FASB Statement No. 5 appropriate? If not, how should yields and impairments be measured and why? (See paragraphs B.33 through B.38 for AcSEC's conclusions.)**

No. The expected-cash-flows benchmark and the interpretation of FASB Statement #5 are not appropriate for a purchased loan that is not impaired under FASB Statement #114.

Issue 5: **The proposed SOP would preserve Practice Bulletin 6's treatment of positive changes in cash flows after acquisition. Such changes would be recognized prospectively by an increase in yield over the remaining life of the loan (see paragraphs 5(b) and 6(b) of the proposed SOP). Is this approach appropriate? If not, how should an investor recognize positive changes in cash flows and why? (See paragraphs B.39 and B.40 for AcSEC's conclusions.)**

No, given that the nonaccretable discount should be reflected in the allowance for credit losses.

Issue 6: **Paragraph 6(b)(2) of the proposed SOP requires that the new, higher yield on a loan (established, for example, by a significant increase in expected future cash flows) must be used as the effective interest rate in any later test for impairment. One practical implication of this provision is that the investor will need to track such changes in yields. Please comment on the appropriateness of this provision. (See paragraphs B.39 and B.40 for AcSEC's conclusions.)**

We do not believe that it is appropriate to use the new, higher yield on a loan resulting from an increase in expected future cash flows as the effective interest rate in an impairment test because it is inconsistent with FASB Statement #114. FASB Statement #114 requires that the original effective interest rate of the loan be used in measuring the loan impairment. This conclusion was based on the premise that using the original effective interest rate would isolate the changes in the fair value of the impaired loan between credit quality deterioration and other factors, such as changes in market rates of interest. We do not believe the Exposure Draft should deviate from the impairment measurement guidelines as established in FASB Statement #114.

Issue 7: **Paragraph 7 of the proposed SOP prohibits investors from accounting for, as new loans, loans within the proposed SOP's scope that are refinanced or restructured after acquisition, other than through a troubled debt restructuring. (Accounting for troubled debt restructurings is already covered by FASB Statement Nos. 15, 114, and 115.) Are the provisions of paragraph 7 appropriate? Why or why not? If not, how should non-troubled refinancings and restructurings be addressed? (See paragraph B.41 for AcSEC's conclusions.)**

Yes. The provisions included in paragraph 7 are appropriate.

Issue 8: **Paragraph 8 of the proposed SOP allows entities to aggregate loans that have common risk characteristics for purposes of applying paragraphs 4, 5, and 6 of the proposed SOP. AcSEC decided that such common risk characteristics should always include financial-asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans? (See paragraphs B.30 and B.31 for AcSEC's conclusions.)**

Exhibit

We do not agree with the requirement that minimum risk characteristics should always be met when aggregating loans for purposes of applying paragraphs 4, 5 and 6 of the Exposure Draft. We believe that strict aggregation requirements would increase the cost of applying the Exposure Draft and may not coincide with how the entity is managing the credit risk associated with the loans. As it relates to the common risk characteristics included in the Exposure Draft, we fail to understand the relevance and importance of using the purchase date as a common risk characteristic. The purchase date is typically not an important determinant in managing credit risk associated with the purchased loans.

We would recommend the minimum risk characteristic requirement be deleted from the Exposure Draft and replaced by an approach similar to that used in FASB Statement #125. Paragraph 37(g) of FASB Statement #125 addresses evaluating and measuring impairment of servicing assets and states that servicing assets should be stratified based on one or more of the predominant risk characteristics of the underlying financial assets. This paragraph provides examples of common risk characteristics that **may** be considered when stratifying the servicing assets. Thus, FASB Statement #125 provides latitude in determining the appropriate common risk characteristics to be used in evaluating and measuring impairment in stratified assets. We believe that a similar type of latitude should be allowed when aggregating loans for purposes of applying paragraphs 4, 5 and 6 of the Exposure Draft.

***Issue 9*: Practice Bulletin 6 addressed whether an investor should accrue income. The proposed SOP eliminates such guidance for loans within its scope because such guidance does not exist for originated loans. Is it appropriate to eliminate the Bulletin's income recognition guidance? If not, what criteria should determine whether the investor should accrue income and why? (See paragraph B.45 for AcSEC's conclusions.)**

No. We would recommend retaining the income recognition guidance of Practice Bulletin 6, so as long as it is consistent with regulatory reporting guidelines established by the regulatory agencies or AICPA Industry Audit Guides. This approach would promote consistency in the income recognition on purchased loans.

***Issue 10*: FASB Statement No. 114, as amended, requires disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded. Should the final SOP require such disclosures for loans that are within the scope of this SOP but not within the scope of FASB Statement No. 114? (See paragraph B.45 for AcSEC's conclusions.)**

No. The scope of the Exposure Draft should not be broader than FASB Statement #114.

***Issue 11*: Disclosure requirements are set out in paragraphs 9 and 10 of the proposed SOP. Are these disclosures appropriate for loans within the scope of the proposed SOP? If not, how should the disclosure requirements be changed and why? Should the final SOP require that accretable yield associated with purchased**

loans be segregated from that associated with originated loans? (See paragraphs B.46 and B.47 for AcSEC's conclusions.)

No. We believe that the disclosure requirements of the Exposure Draft should be consistent (or integrated) with those required by FASB Statement #114. The Exposure Draft disclosure requirements would significantly increase the amount of disclosure included in the financial statements regarding loans. This additional disclosure would be of limited benefit to users of the financial statements due to scope differences between FASB Statement #114 and the Exposure Draft. Additionally, we do not believe that the different information required to be disclosed by the entity relating to originated versus purchased loans (i.e., FASB Statement #114 versus the Exposure Draft) would help the user assess the credit risk profile of the company. As such, the cost of accumulating and disclosing the required information under the Exposure Draft would outweigh the benefit provided to the user of the financial statements.

The disclosures proposed under this SOP represent another argument why an allowance for credit losses should be established at the purchase date. All we are doing here is initially distinguishing between the accounting treatment for originated versus purchased loans, and then aggregating similar credit characteristics for reporting purposes – not a worthwhile exercise.

Issue 12: **The proposed SOP would be effective for financial statements issued for fiscal years beginning after June 15, 2000. Initial application would be required as of the beginning of the investor's fiscal year. Should adoption instead be required as of the end of a fiscal year, without restatement of the results of operations for the preceding twelve months? Why? (See paragraphs B.48 through B.50 for AcSEC's conclusions.)**

If the scope of the Exposure Draft is modified to be consistent with FASB Statement #114, the effective date would appear to be reasonable. We believe that the Exposure Draft should be adopted as of the beginning of the fiscal year instead of at the end of the fiscal year. If adopted at the end of the fiscal year, much work would be needed in accumulating the required disclosure information for the preceding twelve months. Thus, there would not be any significant benefit in adopting the Exposure Draft as of the end of the fiscal year.

Issue 13: **The proposed SOP would apply to loans acquired before the adoption date, including loans acquired in a purchase business combination, and would require transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would be based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than as of the date the investor acquired the loan. Please comment on the appropriateness of the required transition adjustments. Alternatively, should the proposed SOP not be applied to loans acquired before the adoption date and, if so, why? (See paragraphs B.48 through B.50 for AcSEC's conclusions.)**

Exhibit

The Exposure Draft should be adopted on a prospective basis. If applied retroactively, the amount of additional systems work and cost required to accumulate the appropriate information would far outweigh any benefit derived by the user of the financial statements. Additionally, we note that the guidance included in the Exposure Draft is inconsistent with the guidance included in FASB Statement #114 as it relates to implementation. Paragraph 72 of FASB Statement #114 states the following:

> "The Board decided to prohibit retroactive application of the Statement. Because the measurement of impaired loans is based on estimates that are likely to change, the Board questioned the relevance of restatement."

There is no apparent reason why the Exposure Draft should differ from the conclusion reached by the Board.

PETER H. BURGHER
P.O. BOX 1088
15158 WILES DRIVE
CAPTIVA, FL 33924

January 21, 1999

Mr. Brad Davidson, Tech. Mgr.
AICPA
Professional Standards File 2284
1455 Pennsylvania Ave., N.W.
Washington, DC 20004

Gentlemen:

Kindly record this strong objection to the proposed SOP on "Accounting for Discounts Related to Credit Quality".

You have managed to excessively complicate relatively simple subjects, obfuscating reality by mandating meaningless entries in a cookbook effort to remove judgement from the process of credit evaluation.

The idea of recording purchased credit instruments at anything more or less than cost, on acquisition, and cost, less discounted cash flow of expected future payments, at any future time flies in the face of the basic principles of GAAP. In one complex maneuver your proposed SOP renders meaningless the carefully built balance sheets of secondary market holders and renders investor's ability to evaluate the same almost totally impossible. This whole approach is absurd ad infinitum.

I strongly recommend your committee rethink the objectives of this study and try to find a way to express your recommendations consistent with GAAP as we know it, lest reviewers of future financial statements become more befuddled than even you apparently are.

Sincerely,

phb:ed

California Society

Certified Public Accountants

March 10, 1999

Brad Davidson, Technical Manager
Professional Standards and Services, File 2284
AICPA
1455 Pennsylvania Avenue NW
Washington, DC 20004-1081

Re: Exposure Draft, Proposed Statement of Position, *Accounting for Discounts Related to Credit Quality*

Dear Mr. Davidson:

The Accounting Principles and Auditing Standards Committee of the California Society of Certified Public Accountants (AP&AS Committee) has discussed Exposure Draft, Proposed Statement of Position, Accounting for Discounts Related to Credit Quality and has comments on it.

The AP&AS Committee is the senior technical committee of our state society. The committee is composed of 52 members, of whom 8 percent are from national CPA firms, 63 percent are from local or regional firms, 19 percent are sole practitioners in public practice, 6 percent are in industry and 4 percent are in academia.

The AP & AS Committee believes that this document does a good job in providing accounting guidance on this subject.

Our only specific comments are on your "Issue 11" dealing with disclosure matters.

We do not believe that the information provided by paragraphs 10 b. and 10 c. of the proposed SOP are meaningful. In the typical circumstance of an originated loan there is no disclosure of the total expected interest to be collected over the term of the loan. We do not see how these very large numbers are useful. It seems to us that if financial statement users do not ask for these further details about originated loans why do they need it for acquired loans? Disclosure of the carrying interest rate, and perhaps the nominal interest rate, along with the other relevant terms are well understood and meaningful disclosures. It seems to us that users benefit from this information and not the sort of detailed "bookkeeping" information proposed by paragraphs 10 b. and c. In an effort to reduce the so-called disclosure overload we ask that you consider dropping the information provided by paragraphs 10 b. and 10 c.

Thank you for the opportunity to comment on this proposed SOP. Please let us know if you have any questions or require additional information.

Yours very truly,

Andrew M. Mintzer, Chair
Accounting Principles and Auditing Standards Committee

CHASE

The Chase Manhattan Corporation
270 Park Avenue, 28th Floor
New York, NY 10017-2070
Tel 212-270-7559
Fax 212 270-9589

Joseph L. Sclafani
Executive Vice President
And Controller

May 3, 1999

Mr. Brad Davidson
Professional Standards and Services, File 2284
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Re: ***Proposed AICPA Statement of Position, Accounting for Discounts Related to Credit Quality***

Dear Mr. Davidson:

The Chase Manhattan Corporation is pleased to submit its comments on the Proposed AICPA Statement of Position, *Accounting for Discounts Related to Credit Quality* (the "Proposal"). Although Chase appreciates the efforts of the Accounting Standards Executive Committee ("AcSEC") in issuing guidance related to this topic, Chase does not agree with the Proposal as issued. The accounting and methodologies specified in the Proposal are unworkable as they apply to large groups of small-balance homogeneous loans, create accounting inconsistencies, and in some areas, is not in accordance with generally accepted accounting principles ("GAAP"), as discussed below.

The scope of the Proposal should specifically exclude large groups of smaller-balance homogenous loans (i.e., consumer loans, such as credit cards, mortgages and consumer installment loans). The Proposal would create inconsistencies in the methodology in the measurement of impairment regarding large groups of small-balance homogeneous loans depending whether the loan (or loan portfolio) is within the scope of the Proposal or not. This inconsistency would result in similar loans with similar credit risk situations being accounted for and measured differently, since large groups of small-balance homogeneous loans not within the scope of the Proposal would continue to be measured for impairment using models and formulas based on past loss rate history, recent economic events and delinquency rates, as opposed to large groups of small-balance homogeneous loans within the scope of the Proposal being measured for impairment based on anticipated cash flows and yields. The methodologies used for the measurement of impairment for loans with similar characteristics and credit risks should be consistent, regardless whether the loans were purchased at a discount related to credit quality. In addition, applying the methodology and procedures described in the Proposal to large groups of small-balance homogeneous loans would be unworkable since estimating the anticipated cash flows and yields of such loans is impossible given they are constantly changing due to market, economic, and other factors.

Additionally, the Proposal is not in accordance with GAAP. The assumption of the seller's allowance for loan losses is permitted by paragraph 88 of Accounting Principles Board Opinion No. 16, *Business Combinations*

("APB 16") as well as in the Securities and Exchange Commission's Staff Accounting Bulletin No. 61,*Loan Losses* ("SAB 61"). Changes to this methodology can only be made through the issuance of a Statement of Financial Accounting Standard, and not through a Statement of Position ("SOP"). In addition, the concept of requiring the new, higher yield on a loan (established by a significant increase in future cash flows) to be used as the effective interest rate in any later test for impairment is inconsistent with Statement of Financial Accounting Standard No. 114, *Accounting by Creditors for Impairment of a Loan* ("SFAS 114"). SFAS 114 states that if the present value of the expected future cash flows is equal to or greater than the recorded investment in the impaired loan, no impairment is recognized. The Proposal should use the same impairment criteria as specified in SFAS 114. The accounting measurement and treatment of an impaired purchased loan should not be any different from the accounting measurement and treatment of an impaired originated loan. Any divergence from this concept would not be in accordance with GAAP.

Besides the inconsistency in measuring and accounting for impairment of large groups of small-balance homogeneous loans within the scope of the Proposal to those outside its scope as mentioned above, another inconsistency noted would be the accounting treatment of refinanced and restructured (other than troubled debt restructurings ("TDRs")) loans. The Proposal should use the same criterion as Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* ("SFAS 91"), with regards to the accounting treatment of loans that are refinanced and/or restructured (other than TDRs). If the criterion of SFAS 91 is met with regards to loans that are refinanced or restructured, then a new loan has been originated and should not be subject to the Proposal. Any divergence from this concept would create different accounting results for similar loans based on whether the loans are within the scope of the Proposal.

The attachment to this letter expands our position on the above issues as well as provides our comments on specifically requested issues.

We would be pleased to address any questions you may have regarding our comments or discuss our position at your convenience. Please feel free to contact me at 212-270-7559 or David M. Morris at 212-701-7007.

Very truly yours,

Attachment

The Chase Manhattan Corporation
Invitation to Comment on the exposure draft of the Statement of Position, ***Accounting for Discounts Related to Credit Quality***

Issues Specifically Requested for Comment

Scope

Issue 1**: Like the scope of Practice Bulletin 6,** ***Amortization of Discounts on Certain Acquired Loans*****, the scope set in paragraph 3 of the proposed Statement of Position (SOP) includes receivables that are loans and debt securities. The scope is grounded in the definition of** ***loan*** **in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114,** ***Accounting by Creditors for Impairment of a Loan*****, qualified to exclude loans measured at fair value if changes in fair value are included in earnings, loans acquired in a business combination accounted for as a pooling of interests, mortgage loans held for sale, leases as defined in FASB Statement No. 13,** ***Accounting for Leases,*** **and loans held by liquidating banks. Is the scope appropriate? If not, how should AcSEC amend the scope and why?**

No. The scope of the Proposal as it applies to individual commercial loans is appropriate. However, the scope of the proposal should specifically exclude large groups of small-balance homogenous loans (i.e., consumer loans, such as credit cards, mortgages and consumer installment loans). The accounting methodology and procedures as described in the Proposal (and in Practice Bulletin 6 ("PB 6")) are written more for discrete loans (i.e., commercial loans) than large groups of small-balance homogenous loans. Large groups of small-balance homogenous loans should be excluded from the scope of the Proposal for the same reasons why they are excluded from the scope of SFAS 114. The Financial Accounting Standards Board (the "Board") recognized that the accounting methodology and procedures as specified in SFAS 114 could not be applied to large groups of small-balance homogenous loans since these loans typically are collectively evaluated for impairment. The Board also recognized that there are established practices of using formula approaches for estimating losses related to these types of loans. Allowances for loan losses on these types of loans are not evaluated or even established at the specific loan level, but by using models based on various factors (such as past loss rate history, recent economic events and conditions, portfolio delinquency rates, etc.) to estimate the losses of the portfolio. The Proposal would create inconsistencies in the methodology in the measurement of impairment regarding large groups of small-balance homogeneous loans depending whether the loan (or loan portfolio) is within the scope of the Proposal or not. This inconsistency would result in similar loans with similar credit risk situations being accounted for and measured differently, since large groups of small-balance homogeneous loans not within the scope of the Proposal would continue to be measured for impairment using models and formulas based on past loss rate history, recent economic events and delinquency rates as opposed to large groups of small-balance homogeneous loans within the scope of the Proposal being measured for impairment based on anticipated cash flows and yields. The methodology used for the measurement of impairment for loans with similar characteristics and credit risks should be consistent, regardless of whether the loans are purchased at a discount related to credit quality. Applying the accounting methodology and procedures of the Proposal to large groups of small-balance homogenous loan portfolio purchases would be unreasonable and unworkable since estimating the anticipated cash flows (and yields) of a small-balance homogeneous loan portfolio is impossible given they are constantly changing due to market, economic and other factors. This would result in a constant reclassing of amounts between the accretable yield and nonaccretable difference accounts, not to mention the complications it would cause regarding the determination of the proper accretion of the accretable yield. In addition, questions arise regarding the application of the Proposal to revolving credits, such as credit card receivables and/or home equity lines of credit. The concept of contractual payments for revolving credits is virtually irrelevant. Many borrowers use a revolving credit facility (such as credit cards) as a payment instrument, as opposed to a loan vehicle and make payments that are significantly greater than their contractual minimum payments. Future revolving loan balances are decremented by payments, but are augmented by fresh purchases, cash advances and balance transfer volumes. The Proposal would require investors to make allocations of future payments between the loan balances at the time of sale and future loan origingations, a very subjective, impractical task. Furthermore, the yields on these types of credit portfolios may vary significantly due to pricing (including interest, late and other fees) and credit terms (i.e., cash advances at one APR, balance transfers at another APR, purchases at another APR, etc.), and not due to credit quality. If AcSEC does not exclude large groups of small-balance homogeneous loans from the scope of the Proposal, then the Proposal should specifically address the issues relating to large groups of small-balance homogeneous loans and provide specific examples on how the Proposal should be applied to these types of loans (including revolving credits).

The scope of the Proposal should also exclude all loans classified as held-for-sale, and not limited to mortgage loans held-for-sale under FASB Statement 65, *Accounting for Certain Mortgage Banking Activities.* The rise in structured transactions (such as loan securitizations) has resulted in institutions classifying loans other than mortgage loans as held-for-sale. These types of loans should not be subject to the Proposal for the same reason why the mortgage loans held-for-sale are excluded.

Issue 2: **Paragraph 3 of the proposed SOP implicitly excludes originated loans. AcSEC concluded that the criteria in FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, make it unnecessary to establish other criteria that distinguish between loans originated and loans purchased. Is this appropriate? If not, what criteria should be established?**

Yes. One set of criteria for distinguishing originated loans and loans purchased should be consistently applied in all affected accounting transactions. Establishing additional or different criteria for distinguishing originated vs. purchased loans may result in similar loans being accounted for differently depending on whether such loans were subject to the Proposal. Therefore, Chase is opposed to establishing different or additional criteria from the criteria established in FASB Statement No. 125.

Recognition and Measurement

Issue 3: **Paragraph 4 of the proposed SOP would prohibit investors from (*a*) recognizing—as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk—any of the excess of contractual payments receivable over expected future cash flows (*nonaccretable difference*) or, (*b*) displaying such excess in the balance sheet. This prohibition applies to all loans within the proposed SOP's scope, including those acquired in a purchase business combination. Is this prohibition appropriate? If not, how is an investor justified in recognizing—as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk—losses that were not incurred by the investor?**

No. APB 16, paragraph 88 is explicit that receivables are recorded at the present values of amounts to be received determined at appropriate current interest rates, *less allowances for uncollectibility and collection costs, if necessary.* The assumption of the seller's specific loan losses is reiterated in SAB 61, which permits the acquiring entity to assume the seller's allowance for loan losses for the purchased loans (purchased loan portfolio). Changes to this methodology should be made through an issuance of a Statement of Financial Accounting Standard and not through a SOP.

The excess of contractual payments receivable over the expected future cash flows (nonaccretable difference) should be allowed to be recognized as a valuation allowance included in the allowance for loan losses. The nonaccretable difference is exactly the same as a specific allowance for loan loss for that particular loan and it should be classified as such. Requiring a new account for nonaccretable differences on purchased loans (or loan portfolio) would require establishing and maintaining such accounts when the allowance for loan losses is already in existence and established for the exact same purpose. Maintaining a separate nonaccretable account for purchased loans (or purchased loan portfolios) instead of assuming the seller's allowance for loan losses would be administratively burdensome with no added benefit for commercial loans and unworkable for large groups of small-balance homogenous loans. As stated earlier, estimated losses on large groups of small-balance homogeneous loans are evaluated and established on a collective basis and is not loan-specific. Questions will arise regarding the application of the Proposal to large groups of small-balance homogeneous loans, such as what would be the proper determination of the accounting for charge-offs of large groups of small-balance homogeneous loans that are within the scope of the proposal (i.e., should these charge-offs be accounted for as a charge-off to allowance for loan losses or it should be applied toward the nonaccretable difference?).

Issue 4: **The proposed SOP would establish the investor's estimate of undiscounted expected future principal and interest cash flows (*expected future cash flows*) as a benchmark for yield and impairment measurements. This approach recognizes that the investor acquired the loan with the expectation that all remaining contractual principal and interest payments would not be received. Accordingly, the approach interprets FASB Statement No. 5, *Accounting for Contingencies*, to focus impairment on whether it is probable that the investor will be unable to *collect all of the investor's originally expected future cash flows* rather than *all amounts due according to the contractual terms of the receivable.* (See paragraph 5(a) and footnote 5.) Like FASB Statement No. 114, this approach identifies the yield as the discount rate that equates the present value of expected future cash flows with the purchase price of the loan. Are the expected-cash-flows benchmark and the interpretation of FASB Statement No. 5 appropriate? If not, how should yields and impairments be measured and why?**

No. As stated above, an expected cash flows benchmark is appropriate for commercial loans. However, it would not be appropriate for the reasons stated above to apply these criteria to large groups of small-balance homogeneous loans.

Issue 5: **The proposed SOP would preserve Practice Bulletin 6's treatment of positive changes in cash flows after acquisition. Such changes would be recognized prospectively by an increase in yield over the remaining life of the loan (see paragraphs 5(b) and 6(b) of the proposed SOP). Is this approach appropriate? If not, how should an investor recognize positive changes in cash flows and why?**

Yes. The treatment that positive changes in cash flows after acquisition should be recognized prospectively by an increase in yield over the remaining life of the loan is appropriate. However, as noted below, we disagree with the concept of establishing the new higher yield as the effective interest rate in any later test for impairment.

Issue 6: **Paragraph 6(b)(2) of the proposed SOP requires that the new, higher yield on a loan (established, for example, by a significant increase in expected future cash flows) must be used as the effective interest rate in any later test for impairment. One practical implication of this provision is that the investor will need to track such changes in yields. Please comment on the appropriateness of this provision.**

Chase strongly disagrees with the concept of requiring the new, higher yield on a loan (established by a significant increase in future cash flows) be used as the effective interest rate in any later test for impairment and believes it is inconsistent with SFAS 114. SFAS 114 requires that a creditor recognize impairment of a loan if the present value of expected cash flows discounted at the loan's effective rate is less than the *recorded investment* in the impaired loan. If the present value of the expected future cash flows is equal to or greater than the *recorded investment* in the impaired loan, then *no impairment is recognized.* When a loan is purchased at a discount, the recorded investment of the loan is measured at the future expected cash flows discounted at the effective interest rate at the time of purchase. Therefore, impairment of a loan should be recognized to the extent that the recorded investment exceeds the future cash flows discounted at the *original* effective rate of that loan. Changes in yield above the original effective rate should be treated as a change in estimate in accordance with APB Opinion 20, *Accounting Changes,* and the nonaccretable difference and accretable yield should be adjusted appropriately. However, no impairment should be recognized if the future expected cash flows exceed the loan's recorded amount. Any divergence from this concept would not be in accordance with GAAP.

In addition, the criteria of using the new, higher yield on large groups of small-balance homogeneous loans as the effective interest rate in any later test for impairment would be unworkable since the yields on these type of loan portfolios change on a daily basis, depending upon market conditions (such as pricing initiatives, rate and fee environment). Requiring an entity to record an impairment on these loans based on yield would be unreasonable.

Issue 7: **Paragraph 7 of the proposed SOP prohibits investors from accounting for, as new loans, loans within the proposed SOP's scope that are refinanced or restructured after acquisition, other than through a troubled debt restructuring. (Accounting for troubled debt restructurings is already covered by FASB Statement Nos. 15, 114 and 115.) Are the provisions of paragraph 7 appropriate? Why or why not? If not, how should non-troubled refinancings and restructurings be addressed?**

No. There should be consistent accounting for refinanced or restructured loans (other than through TDRs) whether the loan was originated or whether the loan was purchased. Paragraph 12 of SFAS 91 provides guidance that if "the terms of the new loan resulting from a loan refinancing or restructuring other than a troubled debt restructuring are at least as favorable to the lender as the terms for comparable loan to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan shall be accounted for as a new loan." The Proposal should use the same criterion as SFAS 91 with regards to refinancing and restructuring (other than TDRs). If the criterion of SFAS 91 is met with regards to refinancing and restructuring, then a new loan has been originated and should not be subject to the Proposal. Any divergence from this concept would not be in accordance with

GAAP, as well as create different accounting results for similar loans based on whether the loans are within the scope of the Proposal.

Application to Groups of Loans

Issue 8: **Paragraph 8 of the proposed SOP allows entities to aggregate loans that have common risk characteristics for purposes of applying paragraphs 4, 5, and 6 of the proposed SOP. AcSEC decided that such common risk characteristics should always include financial-asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans?**

No. As stated earlier, the scope of the Proposal is geared toward discrete commercial loans. However, applying the Proposal toward large groups of small-balance homogeneous loans would be unworkable, even if they have common risk characteristics. Large groups of small-balance homogeneous loans may have countless "buckets" in which loans would be aggregated based on date of origination, term, geographical location, and credit risk. This is especially true for revolving credits such as credit card receivables. For example, a credit risk in California may be different from a credit risk in New York. To require entities to keep track of the accretable yield, nonaccretable difference, portfolio yield, etc., based on geographical location, date of origination, term, and credit risk would be an enormous administrative burden with no added benefit. These type of loans should be excluded from the scope of the Proposal.

Income Recognition

Issue 9: **Practice Bulletin 6 addressed whether an investor should accrue income. The proposed SOP eliminates such guidance for loans within its scope because such guidance does not exist for originated loans. Is it appropriate to eliminate the Bulletin's income recognition guidance? If not, what criteria should determine whether the investor should accrue income and why?**

Yes. The income guidance in Practice Bulletin 6 for loans within the scope of the Proposal should be eliminated.

Issue 10: **FASB Statement No. 114, as amended, requires disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded. Should the final SOP require such disclosures for loans that are within the scope of this SOP but not within the scope of FASB Statement No. 114?**

No. Disclosure of the creditor's policy for recognizing interest income on loans subject to this Proposal should be required only if the income on such loans is material to the financial statements. If material, then those disclosures should be consistent with those required in SFAS 114, as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures* ("SFAS 118").

Disclosures

Issue 11: **Disclosure requirements are set out in paragraphs 9 and 10 of the proposed SOP. Are these disclosures appropriate for loans within the scope of the proposed SOP? If not, how should the disclosure requirements be changed and why? Should the final SOP require that accretable yield associated with purchased loans be segregated from that associated with originated loans?**

Disclosures (a) and (d) in paragraph 10 are reasonable and appropriate for loans within the scope of the Proposal. However, disclosures (b) and (c) are administratively burdensome to maintain, and would be confusing to financial statement readers with little or no added value. Since the Proposal prohibits the display of the accretable yield and/or nonaccretable difference in the balance sheet, it should not be required to be disclosed in the financial statements. Disclosing activity in and between the accretable yield and nonaccretable difference accounts would be extremely confusing to financial statement users and would place unreasonable burden on the preparers of financial statements, especially if large groups of small-balance homogeneous loans are included within the scope of the Proposal. A significant amount of resources and systems enhancements would be required to capture (if possible) such information. The disclosures required should be no more burdensome than the disclosures required under SFAS 114, as amended by SFAS 118.

Effective Date and Transition

Issue 12: **The proposed SOP would be effective for financial statements issued for fiscal years beginning after June 15, 2000. Initial application would be required as of the beginning of the investor's fiscal year. Should adoption instead be required as of the end of a fiscal year, without restatement of the results of operations for the preceding twelve months? Why?**

No. Chase believes that the adoption of the Proposal should be required at the beginning of the fiscal year for discrete commercial loans.

Issue 13: **The proposed SOP would apply to loans acquired before the adoption date, including loans acquired in a purchase business combination, and would require transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would be based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than as of the date the investor acquired the loan. Please comment on the appropriateness of the required transition adjustments. Alternatively, should the proposed SOP not be applied to loans acquired before the adoption date and, if so, why?**

Application of the Proposal must be made on a prospective basis after the effective date. Chase believes that the application of the Proposal to loans acquired before the adoption date would be administratively burdensome. The calculation of the effective rates, and nonaccretable differences for all loans applicable to the Proposal would require reviewing all outstanding loans purchased at a discount, which would place undue burden on preparers of the financial statements. Entities would not have the system capabilities to distinguish between loans originated and loans previously purchased at a discount related to credit quality (especially large groups of small-balance homogenous loans). In addition, if the Proposal maintains its position that refinancings and restructurings should not be treated as new loans, then entities would be required to identify and review all outstanding refinanced and restructured loans (other than TDRs) and recalculate the effective yield, accretable yield and nonaccretable differences for these large groups of loans, which entities may not have the capabilities to identify such loans. Even if entities have the capabilities to identify such loans, the calculation of a transition adjustment for loans within the scope of the Proposal would create undue burden with no benefit.

CHEVY CHASE BANK

Chevy Chase Bank
8401 Connecticut Avenue
Chevy Chase, Maryland 20815

April 29, 1999

Brad Davidson
Technical Manager
Professional Standards and Services
AICPA
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

re: Proposed Statement of Position - Accounting for Discounts Related to Credit Quality (File 2284)

Dear Mr. Davidson:

Chevy Chase Bank is a $7.8 billion federal savings bank and is the largest bank headquartered in the Washington, D.C. metropolitan area. Chevy Chase acquires loans by origination and purchase, with purchases made in several manners, including indirect purchases and bulk acquisitions. We appreciate this opportunity to offer our comments on certain aspects of the above captioned proposal regarding the acquisition of loans.

As discussed below, we believe (a) that the requirements of the proposed SOP will be difficult to implement in computer systems, (b) that the scope of the SOP requires clarification, (c) that the criteria for aggregation of loans are too narrow and (d) that the effective date should not be before January 15, 2001.

Scope

Issue 1: Like the scope of Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans, the scope set in paragraph 3 of the proposed SOP includes receivables that are loans and debt securities. The scope is grounded in the definition of loan in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan, qualified to exclude loans measured at fair value if changes in fair value are included in earnings, loans acquired in a business combination accounted for as a pooling of interests, mortgage loans held for sale, leases as defined in FASB Statement No. 13, Accounting for Leases, and loans held by liquidating banks. Is the scope appropriate? If not, how should AcSEC amend the scope and why? (See paragraphs B.4 through B.18 for the Accounting Standards Executive Committee's (AcSEC's) conclusions.)

Issue 2: Paragraph 3 of the proposed SOP implicitly excludes originated loans. AcSEC concluded that the criteria in FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, make it unnecessary to establish other criteria that distinguish between loans originated and loans purchased. Is this appropriate? If not, what criteria should be established? (See paragraphs B.6 through B.8 for AcSEC's conclusions.)

Issues 1 and 2 are closely related and we will respond to them together. Chevy Chase believes that the scope of the SOP should be modified to (a) specifically exclude loans purchased on or near the origination date and (b) exclude all loans held for sale.

The scope of the SOP inappropriately captures indirect loan originations. The definition of a transfer, coupled with the investor's expectation of losses, is particularly problematic for subprime loans acquired through indirect means.

Paragraph three states that the SOP "applies to all loans acquired by completion of a transfer and for which it is probable, at acquisition, that the investor will be unable to collect contractual payments receivable..." Investors acquire loans daily from many originators on an indirect basis in the ordinary course of business. The investor will perform due diligence and/or underwriting on individual loans and make its credit decision based on the individual loan. Arguably, in the case of subprime lending some losses are probable at the date of acquisition. However, the lender is not able to determine on which loan the losses will be incurred, but instead will price individual subprime loans to take into account the likelihood that the asset type as a whole will incur losses. The SOP makes no distinction between individual loans and pools of loans and, presumably, applies to both activities.

The premise of the SOP appears to be to isolate, at the date of acquisition, those losses that have occurred from those losses that will occur. If that is the case, then the scope should be modified to exclude individual loans purchased by the investor on or near the origination date (that is, indirect loan purchases should be treated as if the loans were originated).

The definition of "completion of a transfer" in the Glossary specifically excludes "transactions in which the investor acquires loans from the transferor through an agency relationship, for example, when the transferor bears no risk of loss in making and selling the loans." The presumption that indirect loans are already excluded from the scope of the SOP because the definition of "completion of a transfer" excludes loans acquired through an agency relationship may not always hold true. Even though the seller may not be in the business of lending, investors may have recourse to the seller and sellers enjoy profit from making loans. That recourse might be limited or full. For example, loans which default in any of the first three payments might be subject to repurchase by the seller. In other cases, any premium paid by the investor at acquisition might be subject to recapture if the loan prepays or charges off at any time during its life. There are many variations of recourse, however, in all cases the transferor is bearing some risk of loss.

Loans purchased on an indirect basis are very much like originated loans and should be accounted for as such. In that regard, Chevy Chase believes that it is inappropriate to distinguish between originated loans and purchased loans. Consider that as of the origination date the economics for originated loans and loans purchased on or near the origination date are quite similar -- in neither case does the lender expect individual credits to incur losses, but in both cases the lender knows that losses will eventually be incurred on its portfolio of loans. For accounting purposes, the investor will estimate the amount of cash expected to be received over the life of the loan and accrete or amortize into income the difference between the amount paid to acquire the loan and the amount expected to be received. In fact, when the lender sets pricing for either originated loans or loans purchased on an indirect basis, that pricing includes a component for estimated future losses -- that is, the desired return on assets for a single loan or pool of loans includes a loss assumption.

Lenders may also purchase loans on a "mini-bulk" basis -- that is, an originator and investor have agreed that instead of transferring loans daily as they are originated, the loans will be transferred monthly or quarterly. These arrangements are a matter of convenience and should not by themselves cause the loans to be included in the scope of the SOP.

It appears to us that the SOP has been designed primarily to account for bulk acquisitions of loans or acquisition of individual loans that have incurred some level of impairment. Paragraph B.7 confirms our thoughts by indicating that AcSEC believes that loss contingencies related to credit risk should be rare at origination. The application of this SOP to indirect loans acquired on or near the origination date could irreparably harm the indirect lending business.

We concur with AcSEC's exclusion of originated loans from the scope of the SOP and, based on the reasons for that exclusion, urge AcSEC to also exclude indirect lending activities from the scope of the SOP. We believe that the scope of the proposed SOP should be narrowed to exclude indirect loans acquired on or near the origination date. There are many ways to accomplish this modification. Two alternatives would be to exclude from the scope loans that are acquired by the investor (a) during the first 30 days after origination or (b) before the borrower makes the first payment.

We also believe that the exclusion from the scope of "mortgage loans held for sale" should be applied to all loans held for sale. Many lenders fund their operations through securitization. As a result, loans are originated or purchased with the intent of securitization and are marked as "held for securitization or sale" in the balance sheet. That characterization in turn leads to accounting for the loans at the lower of cost or market. It will be onerous to apply the requirements of this SOP to loans which will be sold through a securitization a short time after acquisition. Accordingly, we suggest the word "mortgage" be deleted from the exclusion.

Recognition and Measurement

Issue 3: Paragraph 4 of the proposed SOP would prohibit investors from (a) recognizing-as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk-any of the excess of contractual payments receivable over expected future cash flows (nonaccretable difference) or, (b) displaying such excess in the balance sheet. This prohibition applies to all loans within the proposed SOP's scope, including those acquired in a purchase business combination. Is this prohibition appropriate? If not, how is an investor justified in recognizing-as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk-losses that were not incurred by the investor? (See paragraphs B.26 and B.27 for AcSEC's conclusions.)

We agree that any nonaccretable difference related to the acquisition of loans should not be classified as a valuation allowance or accreted to income. It seems appropriate to us that losses incurred prior to the date of acquisition are not relevant to the accounting for purchased loans. We are concerned, however, that federal financial institution regulators may disagree with that position.

If loans perform exactly as forecasted at acquisition, then the nonaccretable difference will never change. If, however, the performance of a loan or pool of loans is "worse" than believed at acquisition, the regulators might take an "I told you so" approach and begin to require valuation allowances on subsequent purchases of loans. Moreover, regulatory examiners have been trained for years to evaluate loan loss reserves for adequacy. That training is not focused on net carrying amount but rather on whether a valuation allowance exists and whether it is adequate.

We believe that AcSEC should explore this issue with the FFIEC and ask for their views of the proposed accounting. It would be punitive to financial institutions to be caught in a battle between auditors and regulators over whether or not it is appropriate to have valuation allowances on purchased loans at the time of purchase or subsequent to purchase if the loan is performing as expected.

Issue 4: The proposed SOP would establish the investor's estimate of undiscounted expected future principal and interest cash flows (expected future cash flows) as a benchmark for yield and impairment measurements. This approach recognizes that the investor acquired the loan with the expectation that all remaining contractual principal and interest payments would not be received. Accordingly, the approach interprets FASB Statement No. 5, Accounting for Contingencies, to focus impairment on whether it is probable that the investor will be unable to collect all of the investor's originally expected future cash flows rather than all amounts due according to the contractual terms of the receivable. (See paragraph 5(a) and footnote 5.) Like FASB Statement No. 114, this approach identifies the yield as the discount rate that equates the present value of expected future cash flows with the purchase price of the loan. Are the expected-cash-flows benchmark and the interpretation of FASB Statement No. 5 appropriate? If not, how should yields and impairments be measured and why? (See paragraphs B.33 through B.38 for AcSEC's conclusions.)

Issue 5: The proposed SOP would preserve Practice Bulletin 6's treatment of positive changes in cash flows after acquisition. Such changes would be recognized prospectively by an increase in yield over the remaining life of the loan (see paragraphs 5(b) and 6(b) of the proposed SOP). Is this approach appropriate? If not, how should an investor recognize positive changes in cash flows and why? (See paragraphs B.39 and B.40 for AcSEC's conclusions.)

Issue 6: Paragraph 6(b)(2) of the proposed SOP requires that the new, higher yield on a loan (established, for example, by a significant increase in expected future cash flows) must be used as the effective interest rate in any later test for impairment. One practical implication of this provision is that the investor will need to track such changes in yields. Please comment on the appropriateness of this provision. (See paragraphs B.39 and B.40 for AcSEC's conclusions.)

Issues 4, 5 and 6 are closely related and we will respond to them together. We disagree with theapproach taken by AcSEC with respect to the accounting for changes in cash flows. Increases in cash flows should be recognized immediately up to the amount of any previously recognized valuation allowance and prospectively thereafter. However, decreases in cash flows that do not reduce the yield below the yield at acquisition should also be recognized prospectively.The accounting requirements for increased cash flow estimates followed by decreased cash flow estimates seem inconsistent to us. When the increase occurs, the good news is recognized prospectively, presumably because that good news is an expectation and not yet a reality. However, if subsequent to that good news the investor receives bad news and expected future cash flows decline, the SOP will require that bad news to be recognized immediately, even if not all of the prior good news was erased. Decreases in cash flow estimates which follow increases in cash flow estimates should be recognized in income prospectively. The original yield was determined using a set of assumptions and that set of assumptions has changed. The only appropriate measure is to treat that change as a change in estimate and recognize the impact prospectively.

Consider the following two fact patterns. Assume that a loan is purchased to yield 8%. In one scenario, one year after the purchase expected cash flows have increased and the loan is expected to yield 10% for the remainder of its life. The SOP will require that the increase in yield be recognized prospectively. At the end of the second year, expected cash flows have decreased and the loan is expected to yield 9% for the rest of its life. The SOP will require that a valuation allowance be recorded at that time and that income continue to be booked at 10%. In a second scenario, at the end of year one, expected cash flows have increased and the loan is expected to yield 8½%. At the end of the second year expected cash flows have increased again and the loan is expected to yield 9%. In this case, the two changes in cash flow expectations would be accounted for prospectively.

We do not believe that, at the end of two years, these loans which were both expected to yield 8% at acquisition and 9% after two years should be accounted for differently. Instead, we believe that the yield at acquisition should be the benchmark for future measurements of impairment. Changes in estimates resulting in yields which are greater than the initial benchmark should be handled in the same manner regardless of the order in which they occur. In both of the examples above, the benchmark would be 8%. If estimated future cash flows equate to yields above 8%, all changes should be recognized prospectively. If future cash flows equate to yields below 8%, the amount related to the difference between the current expected yield and 8% should be recognized through a valuation allowance. Accordingly, we recommend that the last sentence of paragraph 6(b)(2) be changed as indicated below.

> "The original ~~resultant~~ yield shall be used as the effective interest rate in any ~~subsequent~~ application of paragraph 6(a) herein."

We are very concerned about the implications the proposed SOP will have on loan servicing systems. Specifically, loan servicing systems will require modification to track the accretable yield and nonaccretable differences as well as the current yield. Any changes in any or all of these items as a result of changes in future expected cash flows must also be tracked in order to maintain an audit trail. These items must be stored in the servicing system at the loan level in order to be meaningful. It is likely that loan servicing systems can be modified to capture and store this information, however, such modifications will take time to implement. On the other hand, until the SOP is placed into practice, the need to store and track this information is not fully known. We therefore believe that a field test might be helpful in determining the level and extent that this information will need to be stored on loan servicing systems. Pending the completion of such a field test, we believe it is premature to gauge whether the requirements of the SOP are reasonable or not.

Issue 7: Paragraph 7 of the proposed SOP prohibits investors from accounting for, as new loans, loans within the proposed SOP's scope that are refinanced or restructured after acquisition, other than through a troubled debt restructuring. (Accounting for troubled debt restructurings is already covered by FASB Statement Nos. 15, 114, and 115.) Are the provisions of paragraph 7 appropriate? Why or why not? If not, how should non-troubled refinancings and restructurings be addressed? (See paragraph B.41 for AcSEC's conclusions.)

The prohibition against new loan accounting for refinancings of non-troubled loans is not appropriate, particularly for individual loans within groups. Loan refinancings are a way of life. Borrowers refinance mortgage loans with increasing frequency and investors take that activity into account when evaluating pools of loans. If actual prepayments differ from anticipated prepayments, appropriate adjustments should be made. One of those adjustments should not be to track subsequent refinancings. How far should that be carried for the borrower who annually refinances a mortgage?

In practice, new loan accounting is required for loan servicing rights. The basis in a servicing right related to a loan which is refinanced cannot be carried over to the servicing right related to the new loan. That principle should apply to this SOP as well.

Application to Groups of Loans

Issue 8: Paragraph 8 of the proposed SOP allows entities to aggregate loans that have common risk characteristics for purposes of applying paragraphs 4, 5, and 6 of the proposed SOP. AcSEC decided that such common risk characteristics should always include financial-asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans? (See paragraphs B.30 and B.31 for AcSEC's conclusions.)

Aggregation is a must for purposes of applying this SOP to indirect lending, particularly if AcSEC determines that indirect loans should be included in the scope of the SOP. Moreover, if indirect lending is not excluded from the scope, then the aggregation criteria of "purchase date" and "origination date" will prove to be onerous, burdensome and costly to apply. Consider that indirect lenders purchase loans daily from many different dealers located in various parts of the country. Purchase Date aggregation by itself will create more than 300 pools each year. Multiply that by different interest rates and geographic regions and there could literally be thousands of pools of loans created each year. It appears that indirect lending was not considered when determining the appropriate criteria for aggregation. We strongly urge AcSEC to consider deleting purchase date and origination date from the aggregation criteria.

Aggregation using origination date, interest rate or geographic location, will prove to be burdensome for bulk loan purchasers. Today's economy is robust and loan activity occurs at the national level. More and more credit card, mortgage, home equity and other lenders are making, buying and selling loans nationwide. Pools of loans which have been originated over the course of several months, which have various interest rates and where the borrowers have addresses in many states are frequently traded. In these cases, we believe that the pool should remain in tact for purposes of ongoing accounting and evaluation and that the only relevant criteria is purchase date.

Purchase date aggregation will allow investors to estimate future cash flows and evaluate impairment at the pool level. Even though information will need to be tracked at the loan level, impairment evaluation must occur at the pool level. At acquisition, the investor will make pool level assumptions regarding prepayments, delinquencies and losses. Individual loans within the pool will perform differently over time. It would be onerous and burdensome to split a 1,000 loan pool into 1,000 single-loan pools and record impairment and yield adjustments for each loan individually. We strongly believe that the aggregation criteria not be mandated by the SOP. Investors should be permitted flexibility in determining the appropriate risk characteristic(s) to apply to specific situations.

Effective Date and Transition

Issue 12: The proposed SOP would be effective for financial statements issued for fiscal years beginning after June 15, 2000. Initial application would be required as of the beginning of the investor's fiscal year. Should adoption instead be required as of the end of a fiscal year, without restatement of the results of operations for the preceding twelve months? Why? (See paragraphs B.48 through B.50 for AcSEC's conclusions.)

Any implementation date that does not provide sufficient time for modifications to loan systems to be made will be problematic. Today, most loan servicing systems provide lenders with the capability of entering the amount of discount or premium (whether related to an originated loan under SFAS No. 91 or from an acquisition) onto the system. That system then automatically amortizes or accretes that discount or premium to income. The accounting required under the SOP for purchased loans will require that loan servicing systems be altered to accommodate contractual cash flow, expected cash flows, accretable difference, nonaccretable difference and yield at the loan level. Moreover, accommodations will be required to adjust the accretable difference and the nonaccretable difference when the amount of expected cash flows changes and to track the allowance for loan losses at the individual loan level. Although aggregation is permitted, we have found that unless these types of data are tracked at the loan level, it will be difficult to make the appropriate adjustments when the characteristics of the pools change. For example, the appropriate entries to make when actual losses or prepayments differ from expected losses or prepayments will be easier to determine if the information resides at the loan level. Supplementation of loan servicing systems with subsystems that are external from the vendor-supplied servicing system are problematic -- they will require extensive reconciliation to ensure that the two (or more) systems remain in sync..

Although the accounting requirements proposed by this SOP are closely aligned with the requirements of Practice Bulletin 6, the scope of the SOP is more broad than PB6. Consider that PB6 applies only to loans acquired at a discount from face while the scope of the proposed SOP includes all loans where the investor does not expect to collect all contractual payments, whether purchased at a premium or discount. Dependent upon the specific facts and circumstances, an investor may acquire loans where it does not expect to collect all contractual payments and pay a premium for that loan.[1] Moreover, PB6 relies on the seller's accounting for loans (that is, nonaccrual vs. accrual) in determining whether to accrete discount or not and, in general, purchasers do not buy nonaccrual loans. The net result is that, in practice, very few loans were accounted for on a cost recovery basis under PB6 and loan servicing systems have not been designed to take into account any portion of the purchase price which should not be accreted to income.

This situation is complicated by the fact that most lenders and vendors are unwilling to undertake modifications to any system at a time when Y2K remediation and testing is ongoing. Even if Y2K remediation and testing is complete, most firms would prefer to let their systems remain unchanged during the final months of 1999.

We urge AcSEC to consider an extended implementation period for this SOP and believe that it should be effective no earlier than for fiscal years beginning after January 15, 2001. Use of this date will provide investors and service providers with at least one year following the Y2K turnover to appropriately modify their systems.

[1] Loans with contractual interest rates that exceed current risk-adjusted market rates will likely trade at premiums to principal.

Issue 13: The proposed SOP would apply to loans acquired before the adoption date, including loans acquired in a purchase business combination, and would require transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would be based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than as of the date the investor acquired the loan. Please comment on the appropriateness of the required transition adjustments. Alternatively, should the proposed SOP not be applied to loans acquired before the adoption date and, if so, why? (See paragraphs B.48 through B.50 for AcSEC's conclusions.)

As discussed above, we believe the scope of the SOP is more broad than the scope of PB6 and will apply to more loans, particularly if indirect loans are not excluded and the aggregation criteria are not modified.

We also believe that the proposed transition could adversely impact regulatory capital levels. Subsequent to purchase, investors may have established valuation allowances for purchased loans. The transition indicated by the SOP will eliminate those valuation allowances and replace them with accretable yield and nonaccretable difference. Under current regulatory capital guidelines, certain valuation allowances are treated as tier two regulatory capital. The elimination of valuation allowances will directly impact regulatory capital ratios of financial institutions.

The SOP provides no guidance regarding the method to estimate future cash flows for existing loans. Purchase transactions are conducted at arm's length, but the estimation of future cash flows for loans already owned be the investor is not. Management will need to make judgments regarding expected future cash flows. Application of the SOP to loans acquired before the adoption date is tantamount to asking management to mark such loans to market without looking at market prices.

For these reasons, we don't believe that this SOP should be applied to loans acquired before the adoption date.

We appreciate the opportunity to provide our comments and views on these matters. Should you have any questions or wish to discuss our comments in greater detail, please feel free to call me at (301) 986-6864.

Sincerely,

Joel A. Friedman
Senior Vice President and Controller

JAF/cdb

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CIGNA

May 5, 1999

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Brad Davidson, Technical Manager
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Dear Sir:

CIGNA Corporation is pleased to comment on the Statement of Position (SOP), *Accounting for Discounts Related to Credit Quality,* proposed by the American Institute of Certified Public Accountants (AICPA). From conversations with others in the financial services industry we are concerned that the ED may not be receiving adequate attention. Any entity that acquires another and uses purchase accounting is potentially affected and entities in this situation can be expected to increase based on the Financial Accounting Standards Board's (FASB's) recent tentative conclusion to eliminate the pooling method of accounting. We believe that our comments may be shared by others and urge the AICPA to solicit additional input from others.

We support the AICPA's objective to clear up inconsistency in accounting literature for recognizing impairment on loans and debt securities acquired at discounts attributable to credit quality that are further impaired subsequent to acquisition. AICPA current literature permits an impairment not to be recognized as long as the future cash flows are sufficient to recover the carrying value, even if the future yield is zero. Primary GAAP literature, specifically Statement of Financial Accounting Standard (SFAS) numbers 114 and 115, does not permit this (and does not amend the AICPA literature) so it is appropriate to conform the AICPA's specific rule related to these assets.

We also support elimination of the requirement to use the cost recovery accounting method for loans and debt securities acquired at discounts attributable to credit quality for which the timing and amount of future cash flows is not reasonably estimable. SFAS 118 explicitly permits a choice among alternative accounting methods, including cash-basis and cost-recovery.

However with respect to income recognition, we believe the SOP is more restrictive than primary GAAP and contains undue complexity reminiscent of the income recognition rules originally proposed by SFAS 114 but eliminated by SFAS 118.

The SOP requires the interest method of income recognition and balance sheet valuation for loans subject to its scope. This requirement presumes that loans acquired at discounts related to credit quality are initially measured and should be subsequently measured using discounted cash flows. SFAS 114, in addressing loans with credit quality issues, permits use of the fair value of loan collateral as a practical expedient for the present value of future cash flows. SFAS 115, in addressing the fair value of debt securities, permits use of fundamental analysis to estimate fair value. In presuming a discounted cash flow approach to measuring loans with credit quality issues, at acquisition and subsequently, the SOP imposes the burden of continually recomputing new effective yields (determined as the yield that equates future expected cash flows to the carrying value, adjusted for impairment). This imposes a more specific standard for loans acquired at discounts for credit quality than required under SFAS 114 and 115 and is not cost justified. If the AICPA believes that financial statements should provide information as to the recognized yield on such investments, then disclosure is most appropriate. This could be accomplished, in a manner similar to SFAS 118, by requiring disclosure of the policy for recognizing interest income, the average investment in the loans and the related amount of interest income recognized.

We believe creditors should be allowed choice in the method used to recognize interest income on these loans, just as they are on other loans and debt securities that develop credit quality issues subsequent to acquisition (SFAS 118 explicitly permits choice in method and SFAS 115 is silent), with appropriate disclosure of their choice of accounting.

If we can provide further information or clarification of our comments, please call Nancy Ruffino (860-726-4632).

Sincerely,

Jim Sears

Jim Sears

citigroup

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Controller

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May 5, 1999

Mr. Brad Davidson, Technical Manager
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American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, NW
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Re: Proposed Statement of Position
Accounting for Discounts Related to Credit Quality

Dear Mr. Davidson:

Citigroup appreciates this opportunity to comment on the AICPA's Proposed Statement of Position "Accounting for Discounts Related to Credit Quality."

The proposed Statement of Position ("SOP") would apply to acquired loans and debt securities (collectively referred to as "loans") whether acquired individually, in groups, or in purchase business combinations. The SOP would not apply to loans that are originated by the enterprise. The SOP would require an initial and ongoing comparison of expected and contractual cash flows from the acquired loan. Any shortfall attributable to credit concerns existing at the acquisition date (i.e., contractual cash flows that are not expected to be collected) would be accounted for as "nonaccretable difference." Interest accretion would be limited to the difference between the undiscounted expected future cash flows and the initial investment in the loan.

Based upon our review of the proposed SOP, we cannot support its issuance. The proposed accounting would be disruptive, distortive and extremely impracticable. Receivables that happen to have been acquired at some time in the past will be accounted for in a totally different manner than those that were originated by the current holder, even though they are otherwise indistinguishable. Comparability will be severely diminished.

Further, the proposed new rules are totally unsuited to the vast majority of asset purchases, whereas the impetus for the project seems to be isolated to a narrow set of fringe activities where abuses are said to have occurred – but where current rules and sound professional judgment by companies and auditors should have prevented them. We do not believe that appropriate application of the current accounting and auditing standards would permit a company with a deficient reserve to paper over the deficiency by acquiring low-quality assets, or permit a company to recognize revenue that is unlikely to be realized.

In our view, the accounting proposed in the SOP is operational only for loans that are individually determined to be impaired on the acquisition date using FAS 114 or FAS 115 principles. We do not believe it is feasible to apply the SOP to groups of loans that are evaluated for impairment under FAS 5.

The fundamental problem is that for groups of loans evaluated under FAS 5 it is not possible to determine which specific loans are impaired on the acquisition date (loss incurred by the seller) vs. which specific loans become impaired after the acquisition date (loss incurred by the purchaser). While paragraph 8 of the SOP suggests that its provisions can be applied to groups of loans, this is simply not practicable.

Consider a portfolio acquisition of 1000 similar loans. Assume that some of the loans are past due as of the acquisition date, but that none of the loans have been individually determined to be uncollectible. The credit experience on these types of loans indicates that some past due loans will become uncollectible, some past due loans will become current again, and that some current loans will become past due loans. Prior to the sale, the seller maintained an allowance for credit losses on this loan portfolio in accordance with FAS 5. As is frequently the case in these transactions, the purchase price approximates the face amount of the portfolio, on the basis that the expected interest return on the collectible loans is expected to adequately compensate for the expected credit losses on the uncollectible loans.

Current practice for this type of transaction generally requires that the purchaser's accounting reflect a FAS 5 allowance for the acquired loans similar to the FAS 5 allowance maintained by the seller. Our impression is that this approach is applied in practice to both portfolio acquisitions and business combinations, and it is consistent with the guidance in SEC Staff Accounting Bulletin 61. This accounting is well-understood, widely practiced, and provides an appropriate level of discipline over the accounting for the transaction. Existing requirements for providing a roll-forward of changes in the allowance ensure that additions to the allowance associated with the acquisition of loans is fully disclosed, and SEC registrants provide this roll-forward for the most recent five years.

In contrast, there are clear problems in applying the SOP to a group of acquired loans.

- The first question is whether there is a credit-related discount in the transaction, since the purchase price approximates the face amount. Certainly, the expected credit losses have an effect on the purchase price, and on a portfolio basis there is a difference between the aggregate contractual cash flows and the aggregate expected cash flows which is attributable to credit. However, the SOP does not provide any guidance on measuring the credit discount in these circumstances.

- Second, if the answer under the SOP is that neither a credit discount nor an allowance for credit losses should be recorded by the purchaser, then aggregate losses that were already incurred by the seller and anticipated in the purchase price will inappropriately be charged to the purchaser's income statement as the individual loans are subsequently deemed uncollectible.

- Alternatively, if the answer under the SOP is that an aggregate credit discount for the portfolio as a whole should be recorded by the purchaser, then there is a significant question with respect to the accounting for individual loans that are subsequently deemed uncollectible. The information maintained about individual loans is generally limited to contractual cash flows and actual cash flows. Without a mechanism to track expected cash flows on individual loans, it is not possible to determine whether a charge-off associated with an individual loan should be absorbed against the "nonaccretable difference" established at acquisition or alternatively charged to the purchaser as a post-acquisition credit loss. An arbitrary approach (such as utilizing the nonaccretable discount on a first-in, first-out basis) would clearly be distortive.

As a result, we do not see how the SOP could successfully be applied to groups of acquired loans without specifically tracking expected cash flows associated with each individual loan, which would not be feasible. When loans are acquired as part of a group, the objective is frequently to manage the acquired loans together with originated loans in order to achieve portfolio diversity and economies of scale. A requirement to track all acquired loans individually would be cost prohibitive and run counter to the management objective of the transaction.

As an alternative, we recommend that the accounting proposed in the SOP be limited to acquired loans that are individually determined to be impaired on the acquisition date using FAS 114 or FAS 115 principles. For these loans, we would modify the proposed transition provisions to apply only to loans acquired after the adoption date. The current proposal to adjust the carrying amount of loans acquired prior to the adoption date will be difficult to implement and will unnecessarily confuse pre-acquisition and post-acquisition losses. We see no reason to rewrite history in this regard.

For acquisitions of groups of loans that are evaluated for impairment, we recommend that the FAS 5 approach as described above be applied.

Our responses to the specific requests for comment are attached. I would be happy to discuss these items further at your convenience.

Sincerely,

Roger W Trupin

Roger W. Trupin

Attachment

Citigroup Responses To Specific Questions
AICPA Proposed SOP
Accounting For Discounts Related To Credit Quality

Scope

Issue 1: **Like the scope of Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*, the scope set in paragraph 3 of the proposed SOP includes receivables that are loans and debt securities. The scope is grounded in the definition of loan in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, qualified to exclude loans measured at fair value if changes in fair value are included in earnings, loans acquired in a business combination accounted for as a pooling of interests, mortgage loans held for sale, leases as defined in FASB Statement No. 13, *Accounting for Leases*, and loans held by liquidating banks. Is the scope appropriate? If not, how should AcSEC amend the scope and why? (See paragraphs B.4 through B.18 for the Accounting Standards Executive Committee's (AcSEC's) conclusions.)**

No, the scope is not appropriate. As described in our cover letter, the scope of the accounting proposed in the SOP should be limited to loans that are individually determined to be impaired on the acquisition date using FAS 114 or FAS 115 principles. We do not believe it is feasible to apply the SOP to groups of loans that are evaluated for impairment. Instead, for acquisitions of groups of loans we recommend that a FAS 5 approach be applied, as described in our cover letter.

Issue 2: **Paragraph 3 of the proposed SOP implicitly excludes originated loans. AcSEC concluded that the criteria in FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, make it unnecessary to establish other criteria that distinguish between loans originated and loans purchased. Is this appropriate? If not, what criteria should be established? (See paragraphs B.6 through B.8 for AcSEC's conclusions.)**

No, the SOP's approach is not appropriate. First, we question whether it is appropriate to develop a significantly different accounting model for acquired vs. originated loans. In most respects, the similarities vastly outweigh the differences. Second, FAS 125 was developed from the perspective of the transferor, not the transferee. Any extension of FAS 125 to the transferee should be done explicitly and with adequate due process, not implicitly as in the proposed SOP.

Recognition and Measurement

Issue 3: **Paragraph 4 of the proposed SOP would prohibit investors from (a) recognizing-as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk-any of the excess of contractual payments receivable over expected future cash flows (*nonaccretable difference*) or, (b) displaying such excess in the balance sheet. This prohibition applies to all loans within the proposed SOP's scope, including those acquired in a purchase business combination. Is this prohibition appropriate? If not, how is an investor justified in recognizing-as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk-losses that were not incurred by the investor? (See paragraphs B.26 and B.27 for AcSEC's conclusions.)**

No, the prohibition is not appropriate. As discussed in our cover letter, the scope of the accounting proposed in the SOP should be limited to loans that are individually determined to be impaired on the acquisition date using FAS 114 or FAS 115 principles. For groups of loans we recommend that a FAS 5 approach be applied.

Issue 4: **The proposed SOP would establish the investor's estimate of undiscounted expected future principal and interest cash flows (*expected future cash flows*) as a benchmark for yield and impairment measurements. This approach recognizes that the investor acquired the loan with the expectation that all remaining contractual principal and interest payments would not be received. Accordingly, the approach interprets FASB Statement No. 5, *Accounting for Contingencies*, to focus impairment on whether it is probable that the investor will be unable to *collect all of the investor's originally expected future cash flows rather than all amounts due according to the contractual terms of the receivable.* (See paragraph 5(a) and footnote 5.) Like FASB Statement No. 114, this approach identifies the yield as the discount rate that equates the present value of expected future cash flows with the purchase price of the loan. Are the expected-cash-flows benchmark and the interpretation of FASB Statement No. 5 appropriate? If not, how should yields and impairments be measured and why? (See paragraphs B.33 through B.38 for AcSEC's conclusions.)**

We believe that this approach may be applied to loans that are individually determined to be impaired on the acquisition date using FAS 114 or FAS 115 principles, but cannot be applied to groups of loans that are evaluated for impairment under FAS 5. Furthermore, the SOP's bookkeeping and disclosure requirements would effectively dictate that special accounting systems be developed for acquired loans and would require a level of detailed record-keeping that exceeds what is needed for management purposes. The costs of collecting and maintaining such information would significantly exceed the benefits.

Issue 5: **The proposed SOP would preserve Practice Bulletin 6's treatment of positive changes in cash flows after acquisition. Such changes would be recognized prospectively by an increase in yield over the remaining life of the loan (see paragraphs 5(b) and 6(b) of the proposed SOP). Is this approach appropriate? If not, how should an investor recognize positive changes in cash flows and why? (See paragraphs B.39 and B.40 for AcSEC's conclusions.)**

Yes, this approach is appropriate.

Issue 6: **Paragraph 6(b)(2) of the proposed SOP requires that the new, higher yield on a loan (established, for example, by a significant increase in expected future cash flows) must be used as the effective interest rate in any later test for impairment. One practical implication of this provision is that the investor will need to track such changes in yields. Please comment on the appropriateness of this provision. (See paragraphs B.39 and B.40 for AcSEC's conclusions.)**

No, we believe that this contradicts FAS 114's specific requirement that impairment for acquired loans be evaluated based upon the loan's original effective interest rate.

Issue 7: **Paragraph 7 of the proposed SOP prohibits investors from accounting for, as new loans, loans within the proposed SOP's scope that are refinanced or restructured after acquisition, other than through a troubled debt restructuring. (Accounting for troubled debt restructurings is already covered by FASB Statement Nos. 15, 114, and 115.) Are the provisions of paragraph 7 appropriate? Why or why not? If not, how should non-troubled refinancings and restructurings be addressed? (See paragraph B.41 for AcSEC's conclusions.)**

No, we disagree with the notion that acquired loans that are subsequently refinanced or restructured outside of a troubled debt restructuring can never be viewed as originated loans. In fact, from an economic point of view we do not believe that a rollover of a maturing loan in the normal course of business could be viewed as anything other than a new extension of credit.

Application to Groups of Loans

Issue 8: **Paragraph 8 of the proposed SOP allows entities to aggregate loans that have common risk characteristics for purposes of applying paragraphs 4, 5, and 6 of the proposed SOP. AcSEC decided that such common risk characteristics should always include financial-asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans? (See paragraphs B.30 and B.31 for AcSEC's conclusions.)**

No, the provisions for groups of loans are unworkable. Our concerns on this point are extensively described in our cover letter.

Income Recognition

Issue 9: **Practice Bulletin 6 addressed whether an investor should accrue income. The proposed SOP eliminates such guidance for loans within its scope because such guidance does not exist for originated loans. Is it appropriate to eliminate the Bulletin's income recognition guidance? If not, what criteria should determine whether the investor should accrue income and why? (See paragraph B.45 for AcSEC's conclusions.)**

No, it is not appropriate to eliminate guidance on income recognition. In fact, the decision on whether or not to accrue income is the most important accounting issue associated with this project.

Issue 10: **FASB Statement No. 114, as amended, requires disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded. Should the final SOP require such disclosures for loans that are within the scope of this SOP but not within the scope of FASB Statement No. 114? (See paragraph B.45 for AcSEC's conclusions.)**

Yes. In the absence of clear accounting guidance, such disclosure would be appropriate.

Disclosures

Issue 11: **Disclosure requirements are set out in paragraphs 9 and 10 of the proposed SOP. Are these disclosures appropriate for loans within the scope of the proposed SOP? If not, how should the disclosure requirements be changed and why? Should the final SOP require that accretable yield associated with purchased loans be segregated from that associated with originated loans? (See paragraphs B.46 and B.47 for AcSEC's conclusions.)**

No, the disclosures are not appropriate. We see little benefit in a separate disclosure framework for acquired vs. originated loans. Instead, the disclosure requirements of the SOP should be more closely integrated with the requirements of FAS 114.

Effective Date and Transition

Issue 12: **The proposed SOP would be effective for financial statements issued for fiscal years beginning after June 15, 2000. Initial application would be required as of the beginning of the investor's fiscal year. Should adoption instead be required as of the end of a fiscal year, without restatement of the results of operations for the preceding twelve months? Why? (See paragraphs B.48 through B.50 for AcSEC's conclusions.)**

The proposed effective date is acceptable if the scope of the proposed accounting is limited to loans that are individually determined to be impaired on the acquisition date using FAS 114 or FAS 115 principles. Without this modification, additional time would be required to develop the systems necessary to track expected cash flows on acquired loans on an individual loan basis.

Issue 13: **The proposed SOP would apply to loans acquired before the adoption date, including loans acquired in a purchase business combination, and would require transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would be based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than as of the date the investor acquired the loan. Please comment on the appropriateness of the required transition adjustments. Alternatively, should the proposed SOP not be applied to loans acquired before the adoption date and, if so, why? (See paragraphs B.48 through B.50 for AcSEC's conclusions.)**

No, we would modify the proposed transition provisions to apply only to loans acquired after the adoption date. The current proposal to adjust the carrying amount of loans acquired prior to the adoption date will be difficult to implement and will unnecessarily confuse pre-acquisition and post-acquisition losses.

ERNST & YOUNG LLP

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May 6, 1999

Mr. Brad Davidson
Technical Manager
Professional Standards and Services
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, NW
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Proposed Statement of Position
"Accounting for Discounts Related to Credit Quality"
(File No. 2284)

Dear Mr. Davidson:

While we agree that it is appropriate to address accounting for discounts related to credit quality, we do not concur with the above-mentioned proposed SOP's disclosure requirements which we believe are overly detailed and onerous. Further, we believe that AcSEC should consider providing a practical approach for applying the SOP's requirements to a purchase of a company where substantially all of the loans are performing and only a minor portion have significant credit quality concerns (i.e., those acquired at a significant discount). Unless changes to the final SOP are made that address our concerns, we cannot support issuance of the proposed SOP in its current form. Our detailed comments on these concerns follow:

Disclosure Requirements

The proposed disclosures require a year end schedule showing the contractual payment receivable, nonaccretable difference, accretable yield, and loans purchased at a discount relating to credit quality, net. Also required is a rollforward of the activity in accretable yield and nonaccretable difference. These disclosures appear not to be practical for purchase acquisitions of companies, purchases of long term loans (such as 30 year mortgages) and open ended loans (such as credit cards and commercial lines of credit). We believe that in order to provide these disclosures, companies will need to make systems modifications and increase the ongoing accounting and record keeping related to purchased loans, with little benefit for users. Further, we are concerned that the proposed lengthy disclosures appear to make understanding the accounting more difficult due to the use of technical accounting terminology such as nonaccretable difference and accretable yield, and the requirement to provide a detailed rollforward of the activity in these two accounts—neither of which is displayed in the balance sheet.

As described in the proposed SOP's basis for conclusions, AcSEC believes that the proposed disclosures are needed because, (a) the accounting for purchased loans under the SOP is sufficiently different from the accounting for originated loans, and (b) useful information needs to be provided to readers of the financial statements about the credit quality of purchased loans at each balance sheet date. While we do not disagree with the above conclusions, we believe the proposed disclosures will not be useful to financial statement users and simply add to the disclosure overload burden.

We recommend that AcSEC consider the following alternative disclosures which would be made for the period the loans are purchased:

- the purchase price paid for the loans,
- the unpaid principal balance at date of purchase,
- the expected aggregate estimated future cash flows at purchase date, and
- the effective interest rate (i.e., the discount rate that equates the present value of expected aggregate estimated future cash flows with the purchase price of the loans).

For subsequent reporting periods, any significant changes in the expected future cash flows and resulting effective interest rate would be disclosed along with any related loan loss reserves activity. The extent to which the total purchased loans and related loan loss reserves would need to be separately reported would depend upon their significance to total loans and loan loss reserves, respectively.

We believe that a more summarized, business focused (i.e., plain English) disclosure of this nature would provide the reader with sufficient information and does not contain unnecessary technical accounting terminology. Additionally, we believe that if the disclosure requirements do not include a detailed rollforward of the activity in nonaccretable difference and accretable yield, then the ongoing accounting and related record keeping related to purchased loans become less burdensome.

Further, AcSEC should consider providing a practical approach for applying the SOP requirements to a purchase of a company in which substantially all of the loans are in a performing status and only a minor portion have significant credit quality concerns. For example, it should be possible to apply a practical approach in a situation where a company acquires another company with a loan portfolio of $1 billion of which $950 million is performing with an associated 2 percent allowance. The acquirer should be able to account for these performing loans by carrying over these loans and related allowance to its financial statements thereby excluding these loans from the disclosure requirements. The remaining $50 million of loans with significant credit quality concerns would be accounted for under this proposed SOP and disclosed in the financial statements using our alternative approach. This would significantly reduce the cost of applying the SOP without any loss of important information for users. Moreover, the transition provisions of the proposed SOP should be reexamined to also allow for a more practical approach by limiting the transition reclassification provisions to, at most, the loan portfolio with significant credit quality concerns.

Practical Alternative Method

Additionally, although not as theoretically sound as the proposal, a more practical alternative method for accounting for discounts related to credit quality would be to fix the nonaccretable discount at the acquisition date. All subsequent adverse changes in collection expectations would be recognized as part of the allowance for loan losses. However, because of the high level of risk associated with these loans, collections in excess of expectations would be recognized at the loan's maturity in interest income. In this case the effective yield would be determined at acquisition date and would remain the same throughout the life of the loan, regardless of the loan's performance. In short, a decrease in expected future cash flows would be recorded to the provision for loan losses, and an increase in expected future cash flows would not be recorded as an adjustment to interest income (i.e., in a manner similar to contingent gains) until all expected future cash flows (determined at acquisition date) were received.

Our practical approach would eliminate another anomaly of the proposal. Under the proposal, when there is an increase in expected cash flows in one period the expected yield is increased but then in a later period if there is an equivalent corresponding decrease in expected cash flows, an immediate impairment loss may have to be recognized due to using the recalculated higher yield to make the calculation. This seems inappropriate considering there was no change in estimated total cash flows received when compared to the expected future cash flows at acquisition. Our alternative approach would avoid this result and would further alleviate the information systems and related record keeping requirements of this proposal.

* * * * * * * *

We appreciate the opportunity to present our views on the proposal and would be pleased to discuss our letter with AcSEC or the AICPA staff at your convenience.

Very truly yours,

Ernst + Young LLP

Deloitte &
Touche

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April 29, 1999

Mr. Brad Davidson
Technical Manager Professional Standards & Services
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Accounting for Discounts Related to Credit Quality
Reference File Number: 2284

Dear Mr. Davidson:

We are pleased to comment on the Accounting Standards Executive Committee's (AcSEC's) Proposed Statement of Position, *Accounting for Discounts Related to Credit Quality* (the "Proposed SOP"). We support the issuance of the Proposed SOP as final with the modifications discussed below and in the Appendix to this letter.

The Proposed SOP includes loans and debt securities within its scope, which we support. However, the application of the Proposed SOP to certain instruments is unclear. For example, paragraph 3 of the Proposed SOP indicates that if it is probable at acquisition that an investor will be unable to collect contractual payments, the loan is within the scope of the SOP (except as provided for in the exceptions). Contractual terms of certain investment securities subordinate the security to other investments, for example, subordinated mortgage-backed securities. As a result of the contractual terms of the securities, it is probable at both origination and acquisition that some interest payments will not be collected as due and that some principal write-downs will occur. The Proposed SOP applies when it is probable, at acquisition, that the investor will be unable to collect "the total undiscounted amount of all contractual principal and contractual interest payments to be collected *as scheduled according to the receivable's contractual terms*". [Emphasis added]. It is unclear whether the contractual terms to which the Proposed SOP is referring are those of the subordinated security or of the underlying mortgage loans. Therefore, as it is currently written, it is unclear whether securities, such as those described above, are within the scope of the Proposed SOP. We believe that such securities should be within the scope of the Proposed SOP and that AcSEC should modify the Proposed SOP to clarify that the scope includes subordinated investment securities.

Additionally, paragraph 3 also indicates that loans acquired by the completion of a transfer (as defined in FASB Statement No. 125) are outside the scope of the Proposed SOP. In a securitization, the transfer of loans can be accounted for as a sale only to the extent of consideration received, other than beneficial interests retained. We believe that beneficial interests that are retained by the originating institution after a securitization have not been acquired by the completion of a transfer and represent loans originated, which is consistent with FASB Statement No. 125. However, the risks related to loans originated have been disproportionately transformed in terms of the instrument retained after the securitization. Under that view, the retained interest could be considered an acquired or purchased loan or security. It is unclear whether the Proposed SOP applies to retained beneficial interests and we suggest that AcSEC modify the Proposed SOP to clarify whether the scope includes retained beneficial interests.

Our responses to the specific request for comment in the Proposed SOP are included in the Appendix to this letter. If you have any questions regarding our response, please contact John T. Smith at (203) 761-3199 or Tom Omberg at (203) 761-3067.

Yours truly,

Deloitte & Touche

APPENDIX

DELOITTE & TOUCHE LLP COMMENTS
AMERICAN INSITUTE OF CERTIFIED PUBLIC ACCOUNTANTS INVITATION TO COMMENT
Proposed Statement of Position
Accounting for Discounts Related to Credit Quality

Issue 1: Like the scope of Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans, the scope set in paragraph 3 of the Proposed SOP includes receivables that are loans and debt securities. The scope is grounded in the definition of loan in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan, qualified to exclude loans measured at fair value if changes in fair value are included in earnings, loans acquired in a business combination accounted for as a pooling of interests, mortgage loans held for sale, leases as defined in FASB Statement No. 13, Accounting for Leases, and loans held by liquidating banks. Is the scope appropriate? If not, how should AcSEC amend the scope and why?

We believe that the scope of the Proposed SOP is appropriate; however, as discussed in our letter, the scope requires clarification regarding the specific instruments we identified. Furthermore, the fact that debt securities are included within the term "loan" is too important to be discussed only in the glossary. Additionally, since the term "loan' is defined in FASB Statement No. 114 and that definition does not include debt securities as defined in FASB Statement No. 115, we believe that a separate term should be used to describe the instruments within the scope of the Proposed SOP. We suggest the term "debt instruments". Further, we suggest that the first sentence of paragraph 1 be worded as follows:

> A loan, debt security or a group of loans or debt securities (**debt instruments**[1]) is always transferred at a price less than its **contractual payments receivable**.

We believe that the suggested wording focuses the reader on the fact that debt securities that are accounted for based on FASB Statement No. 115 are within the scope of the Proposed SOP while eliminating the possible confusion about instruments within and outside the scope of other literature.

Issue 2: Paragraph 3 of the Proposed SOP implicitly excludes originated loans. AcSEC concluded that the criteria in FASB Statement No.125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities make it unnecessary to establish other criteria that distinguish between loans originated and loans purchased. Is this appropriate? If not, what criteria should be established?

The distinction between originated and purchased loans is appropriate. However, it is unclear how the Proposed SOP should be applied to participating loans e.g., a correspondent bank originates a loan and a second bank participates in a portion of the lending by providing a determined portion of the loaned cash. From the perspective of the second bank, this transaction is considered a participation purchased. The "purchase" generally occurs at origination therefore, the risk of loss due to credit should be rare because the loan would have just been through a credit review and approval process.

Issue 3: Paragraph 4 of the proposed SOP would prohibit investors from (a) recognizing-as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk- any of the excess of contractual payments receivable over expected future cash flow (nonaccretable difference) or, (b) displaying such excess in the balance sheet. This prohibition applies to all loans within the proposed SOP's scope, including those acquired in a purchase business combination. Is this prohibition appropriate? If not, how is an investor justified in recognizing- as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk- losses that were not incurred by the investor?

We believe that the prohibition is paragraph 4 is appropriate.

Issue 4: The proposed SOP would establish the investor's estimate of undiscounted expected future principal and interest cash flow (expected future cash flows) as a benchmark for yield and impairment measurements. This approach recognizes that the investor acquired the loan with the expectation that all remaining contractual principal and interest payments would not be received. Accordingly, the approach interprets FASB Statement No. 5, Accounting for Contingencies, to focus impairment on whether it is probable that the investor will be unable to collect all of the investor's originally expected future cash flows rather than all amounts due according to the contractual terms of the receivable. Like FASB Statement No. 114, this approach identifies the yield as the discount rate that equates the present value of expected future cash flows with the purchase price of the loan. Are the expected-cash-flows benchmark and the interpretation of FASB Statement No. 5 appropriate? If not, how should yields and impairments be measured and why?

We believe that the expected-cash-flows benchmark and the interpretation of FASB Statement No. 5 are appropriate.

Issue 5: The Proposed SOP would preserve Practice Bulletin 6's treatment of positive changes in cash flows after the acquisition. Such changes would be recognized prospectively by an increase in yield over the remaining life of the loan. Is this approach appropriate? If not, how should an investor recognize positive changes in cash flows and why?

We believe that the prospective-only application of the change in expected cash flows may result in less comparability than the retrospective method. Under the prospective method, there may be some incentive at inception to be aggressive or conservative in estimating future cash flows if ultimately any subsequent adjustments to the estimate can be spread into future earning periods.

A retrospective adjustment of yield produces a more volatile result when estimates differ from actual results. The desire to avoid that volatility provides incentive to make the best estimate possible at the date of purchase. Furthermore, it is not clear to us why a retrospective application should be made when a negative change in cash flows occurs but a prospective application should be made when a positive change in cash flows occurs. We believe that the retrospective application should be applied whether the change in cash flows is positive or negative.

Issue 6: Paragraph 6(b)(2) of the proposed SOP requires that the new, higher yield on a loan (established, for example,.by a significant increase in expected future cash flows) must be used as the effective interest rate in any later test for impairment. One practical implication of this provision is that the investor will need to track such changes in yields. Please comment on the appropriateness of this provision.

We believe that the provisions of paragraph 6(b)(2) are appropriate.

Issue 7: Paragraph 7 of the Proposed SOP prohibits investors from accounting for, as new loans, loans within the Proposed SOP's scope that are refinanced or restructured after acquisition, other than through a troubled debt restructuring. (Accounting for troubled debt restructurings is already covered by FASB Statements No. 15, 114, and 115). Are the provisions of paragraph 7 appropriate? Why or why not? If not, how should non-troubled refinancings and restructurings be addressed?

In practice, financial institutions generally apply their own credit and lending policy to purchased loans that are refinanced for reasons other than those addressed in FASB Statement Nos. 15, 114, and 115. Therefore, we believe that refinanced loans should qualify as new loans, upon refinancing, and should be excluded from the scope of the Proposed SOP.

Issue 8: Paragraph 8 of the Proposed SOP allows entities to aggregate loans that have common risk characteristics for purposes of applying paragraphs 4, 5, and 6 of the Proposed SOP. AcSEC decided that such common risk characteristics should always include financial-asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans?

We believe that the identified minimum characteristics are appropriate. However, it is unclear whether the common risk characteristics are to be applied only in groups of loans that are *exactly the same* or whether application is appropriate when a group is *similar* with respect to the common risk characteristics.

Paragraph B31 refers to FASB Statement No. 125, paragraph 37(g)(i) relating to classification by common risk characteristics. This paragraph in Statement No. 125 permits the stratification of assets based on *one or more predominant risk characteristics*. Reference to this guidance in the Proposed SOP seems to indicate that *similar characteristics* would be a reasonable basis for aggregating a group of loans. There is also guidance in FASB Statement No. 133 that requires stratification of portfolios based on characteristics that respond to market changes within a narrow threshold. It is unclear in the Proposed SOP whether all characteristics should be similar or whether only one characteristic, e.g., geography, must be similar. To avoid confusion with other current generally accepted accounting principles, we suggest that the Proposed SOP be modified to follow specifically either the stratification methodology in FASB Statement No. 125 or 133 and specifically state how many characteristics must be similar for a group to be aggregated.

Issue 9: Practice Bulletin 6 addressed whether an investor should accrue income. The proposed SOP eliminates such guidance for loans within its scope because such guidance does not exist for originated loans. Is it appropriate to eliminate the Bulletin's income recognition guidance? If not, what criteria should determine whether the investor should accrued income and why?

We believe that the provisions of paragraph 9 are appropriate.

Issue 10: FASB Statement No. 114, as amended, requires disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded. Should the final SOP require such disclosures for loan that are within the scope of this SOP but not within the scope of FASB Statement No. 114?

We believe that the disclosure requirements relating to recognizing interest income should also be applied to loans included within the scope of the Proposed SOP that are not subject to disclosure requirements of FASB Statement No. 114.

Issue 11: Disclosure requirements are set out in paragraphs 9 and 10 of the Proposed SOP. Are these disclosures appropriate for loans within the scope of the Proposed SOP? If not, how should the disclosure requirements be changed and why? Should the final SOP require that accretable yield associated with purchased loans be segregated from that associated with originated loans?

The disclosure provisions are appropriate. However, it is unclear whether the term "carrying amount" in paragraph 10(a) includes accrued interest income.

Issue 12: The Proposed SOP would be effective for financial statements issued for fiscal years beginning after June 15, 2000. Initial application would be required as of the beginning of the investor's fiscal year. Should adoption instead by required as of the end of a fiscal year, without restatement of the results of operations for the preceding twelve months? Why?

We agree with the proposed effective date.

Issue 13: The Proposed SOP would apply to loans acquired before the adoption date, including loans acquired in a purchase business combination, and would require transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would be based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than as of the date the investor acquired the loan. Please comment on

the appropriateness of the required transition adjustments. Alternatively, should the Proposed SOP not be applied to loans acquired before the adoption date, and, if so, why?

It is appropriate and practicable to include loans purchased prior to the adoption date within the scope of the SOP. To increase the practicability of applying the transition, benchmarks for yield and impairment for loans purchased prior to adoption should be based on the adoption date rather than the date the loans were originally purchased.

Other Comments

Paragraph 8 discusses the concept of common risk characteristics that should be applied in aggregating loans within the scope of the SOP. Paragraph 8 states that in applying paragraphs 4, 5, and 6, aggregation of loans is appropriate. However, in the glossary of the Proposed SOP, it states that the definition of common risk characteristics is for the purposes of applying paragraph 6, which relates to loans that are not accounted for as debt securities. It appears that the reference in the glossary was also intended to refer to paragraphs 4 and 5.

Paragraph 12(b) includes footnote reference number 10 referring to the term "carrying amount". The term is first used in paragraph 10(a). We suggest that the footnote reference be moved from paragraph 12(b) to paragraph 10(a).

CREDITRUST CORPORATION
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April 29, 1999

American Institute of Certified Public Accountants
Brad Davidson, Technical Manager
Professional Standards and Services, File 2284
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VIA EMAIL: bdavidson@aicpa.org

Dear Mr. Davidson:

This letter is in response to the Proposed Statement of Position (SOP) "Accounting for Discounts Related to Credit Quality".

Creditrust Corporation (NASDAQ-CRDT) is a large information-based purchaser, collector and manager of defaulted consumer receivables. Our defaulted consumer receivables principally consist of credit card accounts that the issuing banks have charged off their books for non-payment. We purchase these defaulted consumer receivables at a significant discount. We recognize income based on the estimated cash recovery in accordance with Practice Bulletin 6, "Amortization of Discounts on Certain Acquired Loans".

The Company is a pioneer in the purchasing of charged-off credit cards and installment loans. The industry and the Company emerged in the early 1990's. Creditrust is the only mono-line publicly held purchaser in an emerging industry. Announcements by several recent institutions indicate the industry is deepening and more public entrants can be expected.

The Proposed SOP, as written, would have a material negative impact on the Company and the industry. Specifically, the Proposed SOP would recognize *any* decrease in estimated future cash flows from the "acquisition" estimate as an impairment loss. We believe that this treatment is overly conservative and does not take into account the significant estimates that are inherent to our industry.

These receivables are purchased in large homogeneous pools of small balance accounts, typically, $2,000 to $4,00 in face value. Thousands of accounts are acquired at each purchase and accounted for one individual static pool. Limited information is available at the time of purchase. Electronic files supplied by sellers are the only due diligence medium. Credit reports are not available until after the purchase and they have little value to recovery estimates. No statistical tool can predict exactly which accounts will pay, how much or when. However, statistical projection models can give a reasonable estimate, though the actual results will vary, and some will vary downward. The very low cost of the receivables is a reflection that the purchaser can expect fluctuations in actual outcomes.

As an example, assume that the Company buys Pool A from an original issuer. Pool A is estimated to yield 350% of the acquisition price. The Company also buys Pool B from an original issuer and is estimated to yield 250% of the acquisition price. The differences in estimated yields must be based on statistical models to handle the massive volume of accounts. Estimates vary between pools A and B due to pool composition (e.g. age, location, and size of accounts) and competitive factors (e.g. number of bidders, seller timeline for resale, etc.). If after six months, the Company lowers its estimate of cash flows (yield) from Pool A to 300% based on actual collection trends, the Proposed SOP would recognize an impairment loss for this change in estimate. No impairment loss would be recognized on Pool B.

We question the proposed accounting because in the example above, the Proposed SOP would require an impairment loss for Pool A which has a revised 300% estimate while Pool B with a lower original estimate of 250% would require no such impairment. Clearly, no impairment has occurred, only a revision to an estimate of somewhat lower yield. We believe that an impairment should only be recognized if the estimate of future cash flows of a pool would not yield full cost recovery plus a reasonable return.

Significant estimates are inherent in and revised estimates likely in the process of purchasing distressed consumer receivables. We strongly believe that the accounting should recognize that changes in estimates are likely and should not result in an impairment loss. We believe APB 20 adequately addresses the necessary disclosure if a revision in estimate is material.

Finally, in the event the American Institute of Certified Public Accountants deems it appropriate to adopt the Proposed SOP for non-consumer receivables such as mortgages and other types of receivables, we believe homogenous pools of distressed consumer receivables should be exempt from the particular application. It is wholly inappropriate to the mass statistical prediction inherent in Creditrust's business and would seriously make the outsourcing of receivables by banks and other issuers more difficult if purchasers withdraw from the market due to the effects of impairment losses resulting form the necessary use of estimates.

Sincerely,

/S/ Richard J. Palmer

Richard J. Palmer, CFO
Creditrust Corporation

FIAC
Financial Institutions Accounting Committee

May 7, 1999

Mr. Brad Davidson
Professional Standards and Services, File 2284
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, NW
Washington, D.C. 20004-1081

Dear Mr. Davidson:

The Financial Institutions Accounting Committee (FIAC) is pleased to provide you with our comments and observations related to the exposure draft of a proposed AICPA Statement of Position (SOP), "Accounting for Discounts Related to Credit Quality." FIAC is a group of 12 financial professionals working in executive level positions in the thrift and banking industries and is affiliated with the Financial Managers Society. The comments within this letter are representative of the FIAC as a whole and do not necessarily reflect individual views of the institutions represented on the Committee.

Introduction

FIAC generally supports the conclusions reached in the proposed SOP, except as noted below. We believe the result with respect to purchased loans is consistent with the economics of loans and investments acquired at a discount, where the discount is attributable, at least in part, to credit quality. We note that several entities are already accounting for such loans and investments in a manner similar to the provisions of the proposed SOP.

Paragraph 8: Application to a Group of Loans

FIAC agrees that for purposes of applying paragraphs 4, 5 and 6 of the SOP, investors should be permitted to aggregate loans that have common risk characteristics and use a composite interest rate. We also agree the excess of contractual payments receivable over the investor's initial investment (whether accretable yield or nonaccretable difference) for a specific loan or group of loans with one set of common characteristics should not be available to "offset" changes in cash flows from a different loan or group of loans with another set of common characteristics. However, AcSEC needs to revise what constitutes common risk characteristics, particularly the reference to purchase date in Appendix B, paragraph B.30. FIAC believes loans purchased during a reasonable time frame, generally a quarter, with otherwise similar risk characteristics should qualify to be included in the same group for purposes of aggregation.

Paragraph 11: Effective Date

FIAC recommends delaying the effective date one year. This delay will give financial institutions and regulators time for training and time to modify the Call Reports and related instructions. Additionally, Information Processing functions in our institutions have generally implemented moratoriums on new programming until Y2K requirements are completed. These moratoriums typically extend through the first quarter of 2000. The programming changes needed to comply with this SOP are significant, and it is unreasonable to assume the programming and testing required could be completed by July 1, 2000.

Paragraphs 12 and 13: Transition

FIAC also recommends applying the provisions of this SOP prospectively. It is our belief the information to make the estimates required by paragraphs 12 and 13 will not be readily available and that developing current estimates of future cash flows for seasoned loans may result in incurring significant additional time and expense with no discernable benefit. It is also highly probable that all loans that meet the scope criteria of this SOP may no longer be individually identifiable without significant effort and cost.

Glossary: Common Risk Characteristics

We believe the minimum common risk characteristics identified in the glossary are too extensive. We recommend that date of origination and geographic location be dropped from the list and that the interest rate and term reflect bands of rates and terms rather than individual rates and terms. We believe the record keeping required by such an extensive and precise list of common risk characteristics would be overly burdensome.

Glossary: Completion of a Transfer

The definition of "Completion of a Transfer" notes that the definition excludes transactions in which the investor acquires loans from the transferor through an agency relationship, for example, when the transferor bears no risk of loss in making and selling the loans. It is FIAC's understanding that sub-prime lenders will traditionally guarantee the purchase price of a potential or originated loan, in basis points, to a loan broker shopping the loan to potential investors. We understand that under the SOP as written, this type of a transaction can not be treated as a purchase of a loan with a discount related to credit because the loan broker is deemed to be acting as an agent for the sub-prime lender, even though the substance of the transaction is one of a loan purchased with a discount related to credit. The FASB should address this issue of agency in relation to FAS 125 as a whole rather than AcSEC addressing this issue in this project.

We appreciate the opportunity to comment on the proposed SOP and hope you find the comments helpful. If you would like to pursue further discussions with FIAC members on the specifics of our comments, please contact Dick Yingst at 312/578-1300.

Sincerely,

Paul J. Devitt

Paul J. Devitt
Chairman

PJD/mlg

cc: Timothy Stier, Office of Thrift Supervision
Robert Storch, Federal Deposit Insurance Corporation
Pascal Desroches, Securities and Exchange Commission
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May 7, 1999

FBOP Corporation

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April 23, 1999

Brad Davidson
Technical Manager
Professional Standards and Services
File 2284
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Dear Mr. Davidson:

First, we would like to share with you a brief perspective of our business and then address the issues of the proposed AICPA Statement of Position (SOP), *Accounting for Discounts Related to Credit Quality.*

Our Business

FBOP Corporation is a $4.5 billion bank holding company with nine banking subsidiaries in Illinois, California and Texas. Since 1987, we have purchased $3.3 billion in loans, primarily at discounts in 189 transactions. The number of individual loans purchased through these transactions is in excess of 2,500. The average discount relative to these purchased loans over this period of time is 20.5%. The discounts are due to various reasons including, but not limited to credit quality, distressed sellers, yield adjustments and market inefficiencies. At December 31, 1998, the consolidated balance sheet included $1.9 billion in gross purchased loan balances offset by discounts of $281 million. Purchased loans represent 55.0% of our total loans as of December 31, 1998. In recent years, the purchased loan discounts have decreased in part, due to improved credit quality of assets purchased, competition and improved market efficiency; however, the market correction experienced late in the third quarter of 1998 caused liquidity problems for many holders of loan portfolios, which enabled us to take advantage of this anomaly. During 1998, we purchased $1.1 billion in loans and commercial mortgage-backed securities at an average discount of 6.5%.

Hopefully, we have succeeded in impressing the significance this proposed SOP could have relative to our business.

Issues Specifically Contained in Proposed SOP

Issue 1: In paragraph B.5, the AcSEC commented on the concepts of contractual payments receivable, initial investment and expected future cash flows. The concepts of contractual payments receivable, initial investment and expected future cash flows are understandable and conceptually correct in an academic sense; however, they pose significant practical issues in implementation and monitoring. Other methods of measurement are already available in the current literature that can achieve similar, if not the same results. I will discuss my specific views and recommendations on this issue later.

Clarification is needed regarding the applicability of this SOP after the completion of transfer. I am assuming any loan acquired at a discount that was not judged probable that the investor will be unable to collect contractual payments receivable will not be governed in any way by this SOP, even if the purchased loan subsequently develops credit quality issues.

Otherwise, the scope is reasonable and should be easy to apply, but it will require additional analysis and documentation at the time of acquisition to identify and segregate such loans for further evaluation and subsequent monitoring.

Issue 2: I agree with the exclusion of originated loans because credit quality/impairment issues are clearly covered in SFAS 114. No further amplification or criteria is needed.

Issue 3: The provisions described in Issue 3 are consistent with other accounting standards.

However, the concepts being conveyed by the proposed SOP are academically correct, but nearly impossible to efficiently implement and monitor. The scheduling of expected cash flows is an estimate subject to many assumptions including prepayment risk, collateral risk, refinancing risk, restructuring risk, etc. As more layers of assumptions are added the less precise the end result may become. Because credit quality is an issue, any estimate of cash flows is likely to be wrong and constantly shifting or changing based on new information. The process of constantly updating estimated cash flows for each purchased loan with credit quality issues is a huge undertaking that would not result in a material change in the financial results of the corporation.

Currently, we have approximately 1,500 loans that may be subject to the proposed SOP. At minimum we may be required to update our assumptions quarterly, which translates to 6,000 credit and cash flow evaluations per year. In order to accommodate the increase in volume we would need to expand our current loan officer staffing at least four times. Our estimated cost relative to the proposed SOP could be in excess of $2 million annually of 4% of our 1998 earnings.

The tracking of the unaccretable difference and the accretable yield and shifting amounts between them on each loan is incredibly labor and technology intensive. I am virtually certain our third party data processor will be unable to accommodate this proposed SOP. Our third party data processor has over 500 clients and we are the only one involved in the purchased loan market to this degree (55% of total loans); therefore, the benefits to other clients will be non-existent. The technology hurtles are huge, expensive, difficult and would ultimately degrade customer service because a separate system will need to be developed and maintained.

A simplified approach would yield the same degree of precision. I will discuss my proposed approach later.

Issue 4: Again, the concept is academically correct. Tracking the original yield to determine future impairment will be difficult and require a complete revamping of loan files, the monitoring process and data processing systems. If a loan is impaired due to credit quality shouldn't the provisions of SFAS 114 apply? Why is it necessary to set up more complicated accounting requirements to obtain the same results?

Issue 5: In theory, we agree with PB 6 and the retention of this provision in the proposed SOP. This provision is consistent with accounting for changes in estimates.

However, as previously mentioned, I do not support the proposed SOP's methods proposed for accounting for such changes in estimates.

Issue 6: Tracking the changes in yields will provide little or no benefit to loan officers or management. This requirement will only complicate the monitoring process.

Issue 7: If the investor refinances or restructures the loan, other than through a troubled debt restructuring, why would it be necessary to continue to apply the proposed SOP? The key is the phase "other than a troubled debt restructuring." Doesn't this mean the loan has cured its past credit quality issues?

If the loan was restructured under the aforementioned scenario the credit quality of the new loan should be not different than any other loan without credit quality issues. The scope paragraphs of the proposed SOP exclude a loan without credit quality issues from consideration. In addition, we would consider this a new origination at current market rates because the borrower could have refinanced or restructured the loan with another financial institution. The refinancing or restructuring of a loan in circumstances other than a troubled debt restructuring is an origination decision not a loan purchasing decision. The provisions of the proposed SOP implies that the financial institution is making an origination decision with an immediate credit quality issue, which, according to the proposed SOP's paragraph B.8 is rare.

The proposed SOP should not always taint a refinanced or restructure loan if the loan was originated in an arms length transaction. A compromise may be a set of tests to determine the existence of an arms length transaction (i.e., loan to value ratio, debt service coverage ratio, market interest rate, amortization method, etc.).

Issue 8: The non-single family purchased loan market is not a cookie cutter market. Each of the loans purchased have asymmetric risk associated with each due to its unique risk characteristics, vintages, loan documentation, collateral condition and industry classification. It would be very difficult for any serious purchaser of loans to categorize the loans and then maintain the analysis in enough detail for it to be meaningful.

The provision seems reasonable, but is impracticable for a portfolio of diverse commercial real estate loans.

Issue 9: The elimination of the PB 6 provision seems appropriate.

Issue 10: We are not clear on those instances when a loan would be within the scope of the proposed SOP, but not within the scope of SFAS 114. Small balance homogeneous loans? Would it practicable to apply the provisions of the proposed SOP to such a population of loans?

Issue 11: Disclosing the amount of accretable yield and nonaccretable difference are meaningless numbers because it ignores the time value of money; therefore, it implies unrealizable value to a non-expert reader of the financial statements. If I had a $1 billion portfolio of 10% loans with and average life of 10 years we would have a disclosure of $1.2 billion. Does this number add value or confuse the reader?

Issue 12: Application as of the beginning of a fiscal year is preferred. If corporations were following reasonable and prudent accounting policies no retroactive restatements would be necessary.

Issue 13: Prospective application to new loans purchased is the most reasonable course of action. The burden of reviewing each loan for credit quality in accordance with the provisions of the proposed SOP and establishing accretable yields and nonaccretable differences would bring our lending side of the organization to a stand still. Application to previously purchased loans should not result in any changes to the financial position of corporations (assuming reasonable and prudent accounting policies).

Recommendation

Develop a policy or policies for amortization of purchased loan discounts that are not limited to issues of credit quality. The policy or policies should contain general parameters for compliance with existing aspects of GAAP. The policies we would recommend are as follows:

1. Management performs a reasonable analysis of each loan or groups of loans purchased and periodically review them to determine if any impairment exists. (SFAS 114)
2. If it is probable that no impairment exists the discount should be amortized to the maturity date of the loan. (SFAS 91 and SFAS 115, etc.)
3. If it is reasonably possible that no impairment exists the discount should be amortized over the expected collection period of the loan (including renewals) which can be longer, but not shorter than the maturity of the loan. (certain aspects of PB6)
4. If it is remote that no impairment exists the discount should not be amortized unless it can be demonstrated how much of the discount is collectable. The discount should be amortized over the expected collection period of the loan (including renewals) which can be longer, but not shorter than the maturity of the loan (certain concepts of 114 and the proposed SOP)
5. If a loan is on non-accrual status or will be moved to non-accrual status, the amortization of discount should cease. (SFAS 91)
6. Disclose only the accounting policy. (SFAS 91 and SFAS 114)

Summary

Existing accounting standards already provide substantial guidance on this issue. The implementation and monitoring of this SOP would be difficult, time consuming and expensive. The implementation and monitoring problems are as complicated as lease accounting before the consideration of ultimate collection and cash flow assumptions. We do not believe any value will be provided to users of financial statements nor will it impact the results of operations. We believe it is more likely that confusion and misinterpretation will be generated from the proposed SOP. As an organization we are very conservative in our accounting for discount amortization. We would hope that others have already appropriately identified the risks and have adopted accounting policies that are reasonable and conservative. Unless we are confident of the ultimate recovery of the gross loan balance, we will not amortize the discount over the period to maturity. We consider many factors including the potential for multiple renewals of individual loans when determining the amortization period, which can be as long as 30 years.

In conclusion, we should look to existing standards or we must look for a more practical solution.

Please do not hesitate to call or E-mail me with any questions or comments.

Best regards,

/S/ Todd C. Schneider
Its Vice President and Chief Accounting Officer

First Tennessee National Corporation
165 Madison Ave.
Memphis, Tennessee 38103

Brad Davidson
Technical Manager
Professional Standards and Services
File 2284
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1455 Pennsylvania Avenue, NW
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First Tennessee appreciates the opportunity to comment on the Proposed Statement of Position, *Accounting For Discounts Related to Credit Quality.* First Tennessee is a nationwide, diversified financial services institution and is one of the 50 largest U. S. bank holding companies with assets of $18.7 billion, shareholders' equity of $1.1 billion and market capitalization of $4.9 billion at December 31, 1998.

Our review of the proposed SOP left us with the question, What is the purpose of this proposed rule change? It appears that Practice Bulletin 6, APB 16 and SFAS 114 provide more than enough guidance on the accounting for loans. The proposed rule change will not provide improved financial statements to the users. It will cause an operational nightmare to financial institutions. Financial institutions must use contractual terms for the recording and tracking of customer transactions. This proposed SOP would require dual systems or system manipulation to comply with the accounting related to purchased loans. System manipulation usually leads to errors and dual systems would be cost prohibitive. While the examples provided are helpful, they are not real life examples. AcSEC should attempt to apply the proposed SOP to the purchase of credit card relationships with 10's of thousands of accounts and revolving credit transactions. The application of the proposed SOP to a business purchase transaction lacks substance. For over 20 years APB 16 has provided more than adequate guidance on the accounting for business combinations. When you acquire a financial institution, you acquire the loans and the allowance for loan losses. You mark the loans to market value related to the current interest rate but the SEC does not allow an adjustment to the allowance unless it flows through one of the entities income statement.

We do not believe that the proposed SOP adds any additional value to the financial statements. It would add additional cost to the operations and possibly result in additional errors and loss of controls due to systems manipulation. The cost far outweigh the benefit. Comments on the requested issues are attached. Again, thank you for the opportunity to comment. If you have any questions, call me at (901) 523-4168.

Respectfully,

Bonnie M. Zoccola

Bonnie M. Zoccola
Vice-President, Accounting Policy

Issue 1- Like the scope of PB 6, the proposed SOP includes receivables and debt securities. It excludes loans measured at fair value if changes in fair value are included in earnings, loans acquired in a business combination accounted for as a pooling of interests, mortgage loans held for sale, leases and loans held by a liquidating bank. Is the scope adequate? If not should it be amended and why?

> *No. All loans acquired in a business combination should be excluded from the proposed SOP. APB 16 provides adequate guidance for the accounting of an acquired business. An entire business is being acquired not just a loan portfolio. Revolving credit facilities such as credit cards and home equity lines of credits should be excluded. It would be very difficult to assign the cash flows to the acquired portion or to any additional advances made since acquisition.*

Issue 2 – The proposed SOP excludes originated loans, is this appropriate?

> *Yes.*

Issue 3 – The proposed SOP would prohibit investors from (a) recognizing – as an adjustment of yield , a loss accrual, or a valuation allowance for the loan for credit risk – any of the excess of contractual payments receivable over expected future cash flows or displaying such excess in the balance sheet. If not, how is an investor justified in recognizing – as an adjustment of yield , a loss accrual, or a valuation allowance for the loan for credit risk – losses that were not incurred by the investor?

> *The proposed SOP does not recognize that in addition to the receivable an investor can purchase a bad debt allowance. Paragraph B.26 omits part of paragraph 88b of APB 16, "General guides for assigning amounts to the individual assets acquired and liabilities assumed, except for goodwill, are: a. Marketable securities at current net realizable values. b. Receivables at present values of amounts received determined at appropriate current interest rates, less allowance for uncollectibility and collection costs, if necessary." It is not necessarily that a loss was incurred by the investor, it could very likely be that an error was made in the estimate of cash flows.*

Issue 4 – The proposed SOP would establish the investor's estimate of undiscounted expected future principal and interest cash flows as a benchmark for yield and impairment measurements. This approach interprets SFAS 5 to focus impairment on whether it is probable that the investor will be unable to collect all of the investor's originally expected future cash flows rather than all the amount due according to the contractual terms of the receivable. Are the expected cash flows benchmark and the interpretation of SFAS 5 appropriate? If not, how should yields and impairments be measured and why?

> *No. Contractual cash flows should be the benchmark for measurement yield and impairment until a purchased loan is impaired under SFAS 114. Contractual cash flows are the basis for the investor's purchase price for unimpaired loans, and they should be the basis for the yield and impairment calculation. Paragraph B.38 assumes an event has occurred that results in a loss to the investor rather than the possibility that an error in originally expected cash flows could be responsible for the short fall. PB 6 has the proper guidance for the change in expected cash flow.*

Issue 5 – The proposed SOP would preserve PB 6's treatment of positive changes in cash flows after acquisition. Is this appropriate? If not, how should an investor recognize positive changes in cash flows and why?

> *Yes.*

Issue 6 – The proposed SOP requires that the new, higher yield on a loan (established, for example, by a significant increase in expected future cash flows) must be used as the effective interest rate in any later test for impairment. One practical implication of this provision is that the investor will need to track such changes in yield. Please comment on the appropriateness of this provision.

> *It would not be appropriate to use the new, higher yield on a purchased loan as the discount rate for an impairment test because it is inconsistent with SFAS 114. SFAS 114 concluded that a loan impairment measurement should reflect only a deterioration of credit quality. SFAS 114 specifies that when a loan is impaired, a creditor should measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate of a loan is the rate of return implicit in the loan (that is, the contractual interest rate). The effective interest rate should not be adjusted for an error in the original estimate of expected future cash flows.*

Issue 7 - The proposed SOP prohibits investors from accounting for, as new loans, loans within the proposed SOP's scope that are refinanced or restructured after acquisition, other than through a troubled debt restructuring. Are the provisions of paragraph 7 appropriate? Why or why not? If not, how should non-troubled refinancings and restructurings be addressed?

> *No. If a loan is refinanced it should be treated as a payoff of a loan and an origination of a new loan. Any discount related to the paid off loan should flow through earnings at the time of the refinancing.*

Issue 8 - The proposed SOP allows entities to aggregate loans that have common risk characteristics for purpose of applying the proposed SOP. AcSEC decided that such common risk characteristics should always include financial-asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans?

> *No. It would be very difficult to aggregate loans by the risk characteristic listed into any size risk bucket that would benefit from aggregation. Strict aggregation criteria would increase the cost of applying the proposed SOP if it did not reflect how the entity manages the credit risk associated with these loans. The purchase date has relatively little importance in evaluating and managing the credit risk associated with a portfolio of loans.*

Issue 9 – PB 6 addressed whether an investor should accrue income. The proposed SOP eliminates such guidance for loans within the scope of the proposed SOP. Is this appropriate?

> *No. The guidance in PB 6 should be maintained.*

Issue 10 – SFAS 114, as amended, requires disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded. Should the final SOP require such disclosure for loans within its scope but not within SFAS 114's scope?

> *No. Further disclosure related to interest income recognition would not add value to the user of the financial statements. Disclosure of 3 or 4 different ways of recognizing interest income would only be confusing to the user.*

Issue 11 – Disclosure requirements are set out in paragraphs 9 and 10 of the proposed SOP. Are these disclosures appropriate for loan within the scope of the proposed SOP? If not, how should the disclosure requirements be changed and why? Should the final SOP require that accretable yield associated with purchased loans be segregated from that associated with originated loans?

No additional disclosure should be required for purchased loans that does not exist today. The disclosures required by the proposed SOP add no benefit to the user of the financial statements and would be very costly to provide if even possible.

Issue 12 - The proposed SOP would be effective for financial statements would be effective for fiscal years beginning after June 15, 2000. Initial application would be required as of the beginning of the investor's fiscal year. Should adoption instead be required as of the end of the fiscal year, without restatement of the results of operations for the preceding twelve months? Why?

Adoption should be as of the beginning of the fiscal year. Adoption at the end of the fiscal year would require disclosures that do not relate to the results of operations presented.

Issue 13 – The proposed SOP would apply to loans acquired before the adoption date and would require transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would be based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than the date the investor acquired the loan. Please comment on the appropriateness of the required transition adjustments. Alternatively, should the proposed SOP not be applied to loans acquired before the adoption date and, if so, why?

The transition adjustment requirements should be dropped from the proposed SOP. With no previous reason to track these loans separately, the loans purchased would have been blended into existing loan portfolio. It would be highly unlikely that the information could be accurately captured and it would be extremely costly to recreate the files. Therefore, the proposed SOP should not be applied to loans purchased before the adoption date.

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May 13, 1999

Brad Davidson
Technical Manager
Professional standards and Services
AICPA
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Dear Mr. Davidson:

We appreciate the opportunity to comment on the proposed Statement of Position, *Accounting for Discounts Related to Credit Quality*, and commend the efforts of the Accounting Standards Executive Committee for addressing these issues.

We support the conclusions reached, with the exceptions noted below. Our comments are keyed to the issues identified in the cover letter of the proposed Statement of Position.

Recognition and Measurement

Issue 4: The proposed SOP would establish the investor's estimate of undiscounted expected future cash flows as a benchmark for future measurement of impairment. The investor would recognize impairment to the extent the investor does not collect all of the originally expected future cash flows. Estimating future cash flows on loans and receivables discounted because of credit risk can be difficult, particularly loans and receivables that are deeply discounted because of the magnitude of the credit risk. Under the proposed SOP, if there is a significant increase in expected future cash flows, the effect would be recognized prospectively. If it is probable the investor will be unable to collect all cash flows expected at acquisition, the loan would be considered impaired, with immediate recognition of the impairment loss. While we agree with the proposed accounting, the unintended effect of the difference in accounting recognition for over and under estimates of expected future cash flows may be to encourage some investors to estimate expected future cash flows conservatively to avoid a possible future impairment write down. We believe this is especially true because of the restrictive criteria for aggregation of loans, which is discussed below in Issue 8.

Issue 7: Paragraph 7 of the proposed SOP prohibits investors from accounting for acquired loans that are subsequently restructured, other than in a troubled debt restructuring, as new loans. We do not understand why an investor should be locked into the requirements of the proposed SOP if it is able to negotiate a new loan with a borrower that would be comparable to a high quality loan. For example, an investor could purchase for $10,000 a nonperforming loan from HUD that has a contractual principal of $50,000 and carries an interest rate of 12 percent. The loan is collateralized by income-producing property. After acquiring the loan, the investor negotiates a new loan with the borrower that has terms that the borrower can meet. Provided the contractual interest rate of the new loan equals or exceeds the rate of the previous loan, it would seem appropriate that this renegotiated loan be accounted for as a new loan in future years. To avoid immediate gain recognition at the time of the restructuring, the nonaccretable difference between the original loan and the restructured loan could be an adjustment to the basis of the new loan, similar to the requirement in SFAS 91 that requires that fees and loan costs be treated as adjustments of the basis of originated loans.

Application to Groups of Loans

Issue 8: The common risk characteristics required for aggregation of loans are very restrictive. We agree that the common risk characteristics should include the type of financial asset and the credit risk. However, because the proposed SOP would cover a wide range of financial assets, investors should be able to exercise judgment to determine to what extent common interest rates, geographic area, term, and date of origination should affect aggregation. A pool of loans can share similar risk characteristics without being essentially the same loan. For example, credit card portfolios may share common risk characteristics, but each portfolio may be a little different in terms of the purchase date, the date of origination, interest rate, and/or geographic area.

As noted in the discussion of Issue 4 above, there may be a tendency for some investors to estimate expected future cash flows conservatively to avoid a possible future impairment write down. We believe this tendency may be aggravated by some of the restrictions on grouping loans. There is a very limited ability to group loans because of the common risk characteristics enumerated in the proposed SOP. Therefore, investors will not be able to offset over estimates of expected future cash flows on a portfolio of loans against under estimates on a portfolio of similar loans (for example, if the portfolios are purchased on different dates). If the common risk characteristics were less rigid and permitted the investor to exercise judgment about what are the appropriate common risk characteristics based on the nature of the financial assets, there would be less of a tendency for investors to apply the provisions of the proposed SOP in an overly conservative manner.

Disclosures

Issue 11: We do not think it is necessary for the accretable yield associated with purchased loans to be segregated from that associated with originated loans.

The disclosures are appropriate, except for the requirement in paragraph 10(c) to disclose the nonaccretable difference. We do not agree that this disclosure is useful, and in fact, think it will be confusing to users of the financial statements.

Effective Date and Transition

Issue 12: We support the effective date being as of the beginning of a fiscal year. We believe it would not be meaningful to adopt the SOP as of the end of the year without restating or remeasuring loans purchased within that year.

Paragraph 11 should provide that financial statements should not be restated; the prohibition related to restatement should not be limited to *annual* financial statements.

Is it AcSEC's intent that early adoption not be permitted?

Issue 13: Although the transition adjustments may be difficult for some entities to apply, we support the proposed transition in the Exposure Draft.

Inability to Predict Cash Flows

The proposed SOP does not include the cost recovery provision of Practice Bulletin 6 for amounts that are not reasonably estimable. The proposed SOP provides that, regardless of whether it is difficult, entities should estimate cash flows. In some situations, however, estimates may be so unreliable that they would distort income recognition. Guidance is particularly necessary for loans purchased at a deep discount. For example, assume loans are purchased for $0.05 for each $1.00 of face amount of the loan. Expected future cash flows are initially estimated to be $0.10. If actual cash flows are $0.08, aggregate income would have initially been overstated 40 percent (($0.10 - $0.08) / ($0.10 - $0.05)).

We recommend that guidance be provided for entities unable to reliably estimate cash flows and for situations in which estimates are consistently missed by material amounts.

We would like to repeat that we strongly support the issuance of the proposed SOP and believe it will be a significant improvement to existing GAAP.

We appreciate the opportunity to express our views. If you would like to discuss any of the issues further, please contact Keith Newton, Regional Director of Professional Standards, at 214-561-2316.

Sincerely,

Grant Thornton LLP

Grant Thornton LLP

ILLINOIS CPA SOCIETY & FOUNDATION®

May 3, 1999

Mr. Brad Davidson, Technical Manager
Professional Standards and Services, File 2284
AICPA
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Dear Mr. Davidson:

The Accounting Principles Committee of the Illinois CPA Society (the Committee) is pleased to comment on the proposed Statement of Position—*Accounting for Discounts Related to Credit Quality.* The organization and operating procedures of the Committee are reflected in the appendix to this letter. The following comments and considerations represent the collective views of the members of the Committee rather than any of the members of the Committee and of the organizations with which they are associated.

The Committee supports the issuance of the proposal as a Statement of Position; however, believes a number of issues need to be modified or clarified before the SOP is issued in final form.

Issue 12—The Committee believes that smaller entities may need additional time in order to modify accounting systems to separately track the information required by the SOP. Accordingly, we believe that initial adoption of the SOP should be allowed at the end of the year of adoption rather than at the beginning of the year. This, in effect, will give entities an additional year to accumulate any necessary additional information.

Issue 13—The Committee believes that full retroactive restatement based upon the acquisition date of the individual loans is the only way to gain true comparability among entities. As outlined in paragraph B 50, the information may not be available to calculate adjustments as of the loan acquisition date. Although, the method proposed in the exposure draft—calculation based on the adoption date of the SOP rather than as of the loan acquisition date— is a practical expedient it will not achieve comparability among entities. Accordingly, because it will not be possible to obtain comparability among entities, we believe that the costs of computing the adjustments at the date of adoption of the statement outweigh the benefits obtained. As a result, we believe the only viable transition alternative is to adopt the statement on a prospective going forward basis.

Paragraphs 5a and 6a make reference to FASB Statement No. 5, *Accounting for Contingencies* when discussing the accounting for a downward revision in the estimate of future cash flows. A number of Committee members believe that the reference to FASB Statement No. 5 may prove confusing and recommend that it be deleted.

They believe that the accounting treatment outlined for positive changes in estimated cash flows is contrary to the gain contingency recognition criteria of FASB Statement No. 5 and, accordingly, to prevent confusion any reference to FASB Statement No. 5 should be eliminated.

New terminology—*accretable yield and nonaccretable difference*—is introduced in this SOP. The Committee believes that the proliferation of accounting jargon should be kept to a minimum. The term *discount* appears to be the common term used to describe the difference between the face amount of an instrument and its carrying value. The Committee questions the need to create an entirely new term of art when it appears that *discount* can be modified for use in this SOP.

Very truly yours,

Richard H. Moseley

Richard H. Moseley, Chair
Accounting Principles Committee

APPENDIX A

ILLINOIS CPA SOCIETY
ACCOUNTING PRINCIPLES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES

1998 - 1999

The Accounting Principles Committee of the Illinois CPA Society (the Committee) is composed of 29 technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to 15 years. The Committee is a senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting principles.

The Committee usually operates by assigning a subcommittee of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting principles. The subcommittee ordinarily develops a proposed response which is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times, includes a minority viewpoint.

ILLINOIS CPA SOCIETY & FOUNDATION

April 30, 1999

Mr. Brad Davidson, Technical Manager
Professional Standards and Services, File 2284
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Dear Mr. Davidson:

The Committee on Auditing Services of the Illinois CPA Society ("Committee") is pleased to have the opportunity to comment on the exposure draft of the "Proposed Statement of Position Accounting for Discounts Related To Credit Quality". The following comments and considerations represent the collective views of the members of the Committee. The organization and operating procedures of the Committee are reflected in the Appendix to this letter.

SUMMARY

Although the proposed SOP addresses the accounting for purchase discounts on certain loans and securities, we offer the following suggested considerations for areas requiring particular attention by auditors. This SOP will become important to auditors with regards to the client's probability assumptions for future cash collections of contractual payments, accounting for subsequent changes in estimates, and for the additional disclosure requirements on which the auditor is also rendering his opinion.

SPECIFIC CONSIDERATIONS

Paragraph 3 indicates that the scope of this proposed SOP would apply to all enterprises that acquire loans. Perhaps this proposal should also address its impact, if any, on accounts receivable securitizations.

Paragraph 5 may also indirectly encourage a company to be "conservative" when allocating purchase accounting adjustments in an acquisition of loans of this type. A company may use very conservative assumptions at acquisition date only to subsequently revise them with the effects recorded in income versus the amortization through goodwill which would presumably be over a longer life. This creates an additional burden on external auditors. We suggest that some consideration be given to discussing the implications acquiring these types of loans when they are part of a business combination.

Paragraph 6 states that *the investor shall continue to estimate expected future cash flows over the life of the loan*. It is unclear as to how often the re-evaluation should take place. Should it be done only when events come to the investor's attention regarding a certain loan, or at each reporting period, or at least annually? Even an annual evaluation of all loans purchased at a discount could be a cumbersome task and could challenge the reasonableness of auditability.

Paragraph 8 should address the temptation to offset good loans and bad loans by broadly defining "common risk characteristics." Without specific prohibitions, this could present difficulties from an audit standpoint.

Paragraph 10 of the proposed SOP requires additional and separate disclosures in addition to disclosures already required by other pronouncements. The illustrated disclosures at Appendix A.18 and A.19 are very detailed, to the extent that Appendix A.18 is two full paragraphs that also includes definitions. Keeping in mind that these disclosures are based on client estimates, assumptions and probabilities in assessing collectibility and expected future cash flows, perhaps the essence of the SOP can be captured in significantly less detailed disclosures.

To illustrate, it is not important for the investor to disclose the components of the net amount recognized in the financial statements or the activity in those components. Basically, an investor has paid a price for a loan and that price is the investor's cost. The investor makes estimates of future cash flows and the difference is recognized as income over the life of the loan. These estimates are re-evaluated (how often ...). Those facts are important to the user of the financial statements. Therefore, the amount of loans purchased at a discount included in the balance sheet as well as the amount of income recognized on those loans during the period would be very informative disclosures. If there were significant changes made to estimates or impairment recognized, those facts would also be informative. Any further disclosures would seem cumbersome and very difficult to understand. As currently drafted, the proposed disclosures may appear to be a good example of disclosure overload.

The exposure draft indicates that it will supersede Practice Bulletin 6 (PB 6). This bulletin provided very specific guidance to use the cost-recovery method in circumstances when future cash collections were not both reasonably estimable and probable. PB 6 goes on to clarify that *"If at the acquisition date it is known that interest income on a particular loan is not being recognized by the seller because of concerns about collectibility of the loan principal or interest, it should be presumed that the loan does not meet the criteria above."* For start-up entities or entities with little history to support their cash flow assumptions, the guidance in PB 6 was very useful. The exposure draft does not provide any guidance for start-up operations or entities with little history to support their assumptions. (Similar to SFAS 109, when an entity has a limited operating history and has no historical evidence to substantiate realization of deferred tax assets, a valuation allowance is usually warranted.) We believe this area can be very difficult for auditors to assess and recommend that the SOP include guidance regarding the assumptions start-up companies and those with limited operating history should use.

GENERAL CONSIDERATION

Inherent throughout this proposed SOP may be the auditor's concern for the client's understanding and implementation of "probable" within the scope and definitions of FASB Statements No. 5 and No. 114. Although facts and circumstances will of course vary from case to case, the proposal includes very detailed journal entries/accounting examples on how to apply the provisions of the proposed SOP. To complement this accounting guidance, perhaps an example or two of some underlying factor(s) or assumption(s) to be considered as achieving "probable" status within the limited scope of this SOP would be beneficial. (Appendix B.44 states that AcSEC noted that FASB found this requirement to be unnecessary for FASB No. 5.) Since this highly technical proposed SOP requires specialized knowledge, perhaps this additional guidance regarding "probable" should be reconsidered for limited inclusion in this proposed SOP.

Sincerely,

James A. Dolinar
Chair, Auditing Services Committee, Illinois CPA Society

APPENDIX A

ILLINOIS CPA SOCIETY
AUDITING SERVICES COMMITTEE
ORGANIZATIONAL AND OPERATING PROCEDURES
1998 - 1999

The Auditing Services Committee of the Illinois CPA Society (the Committee) is composed of nineteen technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to fifteen years. The Committee is a senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of auditing standards.

The Committee usually operates by assigning a subcommittee of its members to study and discuss fully exposure documents proposing additions to or revisions of auditing standards. The subcommittee ordinarily develops a proposed response which is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint.

KeyCorp
127 Public Square
Cleveland, Ohio 44114-1306

April 29, 1999

Mr. Brad Davidson
Professional Standards and Services
File: 2284
American Institute of Certified Public Accountants
1455 Pennsylvania Ave. NW
Washington, DC 20004-1081

Dear Mr. Davidson:

We are writing in response to your invitation to comment on the Proposed Statement of Position, *Accounting for Discounts Related to Credit Quality* (the "SOP").

KeyCorp ("Key"), headquartered in Cleveland, Ohio, is a bank-based financial services company that, at March 31, 1998, had assets of approximately $80 billion. One of the primary businesses of Key is the extension of credit to borrowers in the form of consumer and commercial loans. Key, like most of its peers, generally invests in loans originated through direct (branch-based) and indirect (dealer-based) channels. Purchases of loans occur less frequently, but can be a very important means of acquiring loans and balance sheet management. In the past, Key has purchased large blocks of homogenous loans; specific newly originated loans, on a wholesale basis; and, most significantly from a historical perspective, loans in connection with a purchase business combination. We appreciate the opportunity to comment on the SOP as it could significantly affect the accounting for our business. We have chosen to provide specific comments on certain issues identified for consideration by the AcSEC after providing our overall concerns about the project.

Key's Position
The SOP provides unneeded guidance in the area of accounting for purchased loans. The current accounting framework provided by Practice Bulletin 6: *Amortization of Discounts on Certain Acquired Loans* ("PB 6") and SFAS No. 114, *Accounting by Creditors for Impairment of a Loan* ("FAS 114") has produced sound guidance and disclosures that provide the user with an accurate view of the credit quality of both purchased and originated loans. If adopted in its present form, the SOP could significantly reduce the comparability of balance sheets from one entity to another. Since the credit-related discount will not be displayed as a valuation allowance, it will

be difficult to compare the credit quality of a purchased portfolio with that of an originated portfolio. This will only serve to reduce the usefulness of the financial statements as a whole. In addition, the scope appears to be overly broad and encompassing and provides none of the practicality exceptions that are found in FAS 114. As such, the cost-benefit of the SOP must be reconsidered. The SOP will require entities to monitor the credit quality of every separately purchased portfolio. At best, for larger companies, this will require significantly more credit resources, system modifications and analytical work; at worst, for smaller companies with a significant amount of loan purchases, the accounting model will be virtually impossible to maintain. Overall, we believe the new accounting and disclosures will weaken financial reporting, and the additional recordkeeping to support the SOP's reporting requirements will be burdensome and create an operational challenge. In summary, we do not support the SOP.

Issue 1 – Like PB 6, the scope of the proposed SOP includes loans and debt securities. The definition of loan is that in SFAS 114, but the scope of the proposed SOP excludes loans measured at fair value through earnings, loans acquired in a business combination accounted for as a pooling of interests, mortgage loans for sale, leases, and loans held by liquidating banks. Is this scope appropriate? If not, how should the scope be amended and why?

Should the SOP remain, the scope of the SOP should be narrowed as it represents too significant a change to current practice. Consideration needs to be given to eliminate the SOP's applicability to bulk purchases of smaller-balance, homogenous loans, consistent with the exception provided by FAS 114. The SOP unnecessarily expands the use of credit-related discounts to loans acquired in a purchase business combination. There already exists significant guidance in practice from the SEC that adequately addresses the accounting for loan loss allowances acquired in a purchase business combination. The SOP would be an inappropriate addition to the technical literature in this area.

It appears that the scope of the SOP is intended to cover all purchased loans (other than those covered by the scope exception in paragraph 3) that have a credit-related discount. The SOP should claify whether it is intended to cover only "loans purchased at a discount" or "loans purchased which included a credit-related discount". The distinction to be made is that in a falling interest rate environment, it would not be uncommon to purchase loans at a premium (use 102% for example) whereby the purchase price is comprised of a market rate premium (5%) partially offset by a credit-related discount (3%). The SOP should be clarified to specifically include these types of loans.

Issue 3 – For loans in the scope of the proposed SOP, paragraph 4 of the proposed SOP would prohibit investors from (a) recognizing – as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk – any of the excess of contractual payments receivable over expected future cash flows (nonaccretable difference) or, (b) displaying such excess in the balance sheet. Is this prohibition appropriate? If not, how is the investor justified in recognizing – as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk – losses that were not incurred by the investor?

We believe that discounts related to loans that are not considered impaired under FAS 114 should be recognized on the balance sheet as a discount and accreted as an adjustment to yield. It is important to continue the loan impairment model currently in place under FAS 114. The current model is consistently applied and easily understood.

Issue 8 – The proposed SOP allows entities to aggregate loans that have common risk characteristics for purposes of recognition and measurement. The common risk characteristics should always include financial-asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans?

The SOP will require entities to look at specific groups of purchased loans prior to the determination about whether additional aggregation can occur. We disagree that the common risk characteristics listed above *must* be included in the determination of aggregation. Each lending institution has its own set of credit criteria that are used to determine common risk profiles. We believe that the credit risk factors normally used by an institution's own management to aggregate and quantify risks should be the sole aggregation criteria promulgated by the SOP. We disagree that the other factors, such as the general level of interest rates and the date of origination, have a meaningful bearing on aggregating risk – factors that affect credit risk should be the only characteristics that are used to determine commonality among various purchased loans.

Please consider that to the extent the SOP dictates specific factors to be used to aggregate risk, the more difficult the final SOP will be to implement. The AcSEC must keep in mind the practical and operational difficulties associated with the SOP and apply a cost-benefit analysis.

Issue 11 – Entities would disclose the following separately for loans accounted for as debt securities and loans not accounted for as debt securities: a) carrying amount at the beginning and end of the period; b) amount of accretable yield at the beginning and end of the period reconciled for changes; c) amount of nonaccretable difference at the beginning and end of the period reconciled for changes; d) amount of loss accruals and reversals made for loans not accounted for as debt securities during the income statement period. Are these disclosures appropriate for loans within the scope of the proposed SOP? If not, how should the disclosures be changed and why? Should the final SOP require that the accretable yield associated with purchased loans be segregated from the accretable yield associated with originated loans?

The SOP establishes significant and unnecessary accounting and reporting differences between originated and purchased loans. The disclosures do not reflect the model applied by FAS 114, which requires disclosure of the criteria used in establishing the allowance for loan losses for different loan categories. The SOP's disclosures will not provide users with a complete understanding of the credit risk associated with the purchased portfolio. We are very concerned that, with the high number of purchase business combinations among financial institutions, it will be very difficult to compare the adequacy of the allowance for loan losses (the traditional barometer of credit quality) among different institutions. Users will consult the notes to the financial statements to determine the amount of allowance for loan losses plus credit-related discount an entity has recorded to determine its true loan loss coverage. In effect, users will treat the discount as a valuation allowance.

We believe the requirement to reconcile the changes in both accretable and nonaccretable yield is a worthy disclosure. However, the SOP already requires a large number of disclosures; we believe the AcSEC again needs to consider the cost-benefit analysis of the disclosures discussed in b.) and c.) above. When multiplying the disclosure requirement across dozens of purchased portfolios, institutions (including Key) will need to adopt methods of aggregation just to meet the disclosures. There are many in industry who believe that there is information overload in the financial statement disclosures; this SOP only compounds the problem.

Issue 13 – The proposed SOP would apply to loans acquired before the adoption date and would require transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would be based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than the date the investor acquired the loan. Please comment on the appropriateness of the required transition adjustments. Alternatively, should the proposed SOP not be applied to loans acquired before the adoption date and, if so, why?

The SOP should only require prospective adoption. Currently, most institutions do not track purchased loan portfolios at the level of detail needed to make the appropriate estimates, nor are all purchased loans separately tracked. The system changes would need to be done on many separate application systems. We do not believe the effort and cost involved are justified, nor are we sure that the information is available to accomplish the SOP's requirements.

We hope that this discussion has been useful to you. We would welcome the opportunity to discuss these issues with you in more detail; please contact either Bill Schlag, Manager of Accounting Policy and Shareholder Reporting (216) 689-4682 or me (216) 689-1773 at your convenience.

Sincerely,

James J. Malerba
Executive Vice President and
Corporate Controller

SOP.doc

Author: MIME:asuffrin@lcpa.org at INTERNET
Date: 4/28/99 5:06 PM
Priority: Normal
TO: Brad Davidson at AICPA4
CC: AEROEVENS@aol.com at INTERNET
Subject: Exposure Draft

Brad Davidson
Technical Manager
Professional Standards and Services
File 2284
AICPA
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Comments on Exposure Draft
Proposed Statement of Position
Accounting for Discounts Related to Credit Quality

Date of Exposure Draft: December 30, 1998

Date Comments Should Be Sent: April 29, 1999

Comments Submitted by: Accounting and Auditing Standards Committee, Society of Louisiana CPAs

Specific comments

We find the illustrations in Appendix A to be very helpful in understanding the proposed statement.

While we do not have any specific recommendations regarding the required disclosures, it does appear that any entity affected by this proposed statement would have another round of extensive disclosure requirements.

Paragraphs 5b and 6b need clarification as to what constitutes "significant increase" and "significantly greater". Can these items be translated into quantified amounts, such as 10%, 20%, etc.?

Thank you very much for your consideration of the above comments.

Mellon Bank

One Mellon Bank Center
Pittsburgh, PA 15258-0001

(412) 234-4611 Office
(412) 236-5909 Fax

Steven G. Elliott
Senior Vice Chairman and
Chief Financial Officer
Mellon Bank, N.A.

April 29, 1999

American Institute of Certified Public Accountants
Attn: Brad Davidson (bdavidson@aicpa.org)
Professional Standards and Services, File 2284
1455 Pennsylvania Avenue, N.W.
Washington, DC 20004-1081

Proposed Statement of Position "Accounting for Discounts Related to Credit Quality"

Dear AICPA:

Mellon Bank Corporation appreciates the opportunity to comment on the proposed Statement of Position, "Accounting for Discounts Related to Credit Quality." Mellon is a bank holding company with approximately $50 billion in total assets, including approximately $32 billion in loans.

We appreciate the important role of the AICPA in promulgating proper and meaningful accounting and reporting. Mellon has acquired a number of bank subsidiaries in recent years, so it will be affected by the proposed SOP. Further, Mellon is a user of financial statements in its roles as lender and asset manager. Mellon would thus welcome any accounting guidance that presents, at an acceptable cost, more meaningful and useful information than that which results from current generally accepted accounting principles. Unfortunately, we believe your proposed SOP would not do this. In addition, we do not believe there is a demand by practitioners, industry or investors for the changes that would result.

We do not think that a void currently exists in the application of FAS 5, 114 and 118 to provide for losses inherent in a loan portfolio. We also believe that users will find your proposed "accretable yield" and "nonaccretable difference" to be confusing and not to be an improvement from reporting loans based on contractual principal and an allowance for credit loss. Further, creating accounting differences between loans that are originated and purchased will be confusing and not representationally faithful. In addition, initial carrying values will reflect buyers' assumptions for loans (e.g., discount rates and cash flow estimates) that may vary significantly by buyer; this would reduce comparability of financial statements among buyers. Lastly, the enormous burden of separately tracking loans acquired in business combinations from those originated and estimating cash flows on a loan-by-loan basis would not provide information otherwise useful by management, would hinder attempts to integrate application and reporting systems and result in significant costs.

The remainder of this letter addresses the specific issues on which you requested comments.

Scope: Issues 1 and 2

The proposed SOP appears to include all purchased loans, not just those whose purchase price reflects a discount specifically due to credit quality. This is, in part, because the assessment of the probability of collection based on current information and events (FAS 114, paragraph 8) is not included in the scope of this proposed SOP.

The premise in the first paragraph that loans are "always transferred at a price less than its contractual payments receivable" is misleading. It is so broad that the SOP's scope by definition essentially includes each and every loan acquired in a purchase business combination and would require cash flow analysis on nearly a loan-by-loan basis. In a period of stable interest rates, it is entirely likely that a buyer would be willing to pay the amount of contractual principal receivable and have every expectation that interest and principal will be fully collected. This SOP seems to presume that the price in a purchase business combination reflects a specific negotiated amount for loan assets included in the purchase. Our experience is that the price principally reflects franchise value and that the adjustments you are proposing would typically have to be identified and estimated subsequent to the purchase date.

If the SOP is not retracted, we believe the scope should be more restrictive, to exclude debt securities and include only credit-impaired loans under the application of FAS 114. Smaller-balance homogeneous loan portfolios should also be excluded, as they are in FAS 114.

Recognition and Measurement: Issues 3 – 7

Contractual cash flows should be the benchmark for measurement of yield and impairment unless and until a loan is determined to be impaired under FAS 114. Contractual cash flows are the principal basis upon which asset values are evaluated and prices are negotiated. They provide an objective basis upon which to subsequently measure changes, and should be the basis for yield and impairment calculations. FAS 5 recognizes that while a loan-by-loan analysis may not identify any one loan that won't be collected, historical experience indicates that there are inherent losses currently in the portfolio.

It is inappropriate to assume that price always reflects "a price less than its contractual payments receivable." When pools of loans with varying origination dates are acquired through a purchase business combination, it is not unusual to acquire both loans at a discount and loans at a premium, yet this SOP would imply that all loans are bought at a discount. A loan acquirer's price may reflect many factors other than probable credit losses, such as the acquirer's range of market pricing, varying tolerance for liquidity, concentration or credit risk, loan servicing efficiencies, or a different intent of asset realization than the seller.

We believe that the proposed prohibition against displaying the excess of the contractual payments receivable over expected cash flow (nonaccretable difference) is inappropriate. Some financial statement users may want to apply different collectibility assumptions to contractual balances or assess a company's risk profile; such prohibition would deny them that opportunity. Such basic historical measures as loan loss reserve as a percentage of loans would lose meaning and make comparisons to other banks inappropriate.

We agree that a loan that is refinanced or legally restructured, other than through a troubled debt restructuring, should not be accounted for as a new loan. Accretable yield on such loans should be recognized prospectively.

Application to Groups of Loans: Issue 8

While it is our opinion that the proposed SOP should be restricted to impaired loans, if it moves forward the seven minimum "common risk characteristics" would be excessive. While these could be suggested as examples of common risks to stratify risk, defining all seven as minimum characteristics would not be appropriate in all instances. Predefining criteria will increase cost significantly for those who do not already accumulate and track this information.

With respect to the seven criteria chosen:

- "Purchase date" and "date of origination" generally are not meaningful aggregation criteria in assessing future cash flows.
- We presume that "financial asset type" is to be interpreted broadly and accordingly suggest this be deleted. Narrow interpretation would be onerous.
- We presume "term" to indicate "remaining term" which would be inherent in the calculation of future cash flows and would thus not be a meaningful aggregation criteria. "Original term" would not be a meaningful aggregation criteria in assessing future cash flows.
- Geographic location can be an appropriate aggregation criteria in some instances, but should not be required in all instances. Implementation issues (e.g., customer HQ vs. operations sites; multi-state and multi-national customers; parent guarantees that negate geographic risk, etc.) complicate application of this criteria.

Income Recognition: Issues 9 and 10

If you retract this proposed SOP, PB6 should be retained. However, income recognition guidance discussed in Practice Bulletin 6 is generally duplicative of guidance by the OCC, Federal Reserve and SEC. Elimination via superceding PB6 will not leave a void.

We do not believe that disclosures for loans within the scope of this SOP, but outside the scope of FAS 114, should be required. The scope of this proposed SOP should not be broader than the requirements under FAS 114.

Disclosures: Issue 11

Disclosures under the proposed SOP would be excessive and confusing. We do not believe most readers will fully understand the distinction between "accretable yield" and "nonaccretable difference" or find the periodic reporting of the changes therein useful. Readers may consider "nonaccretable difference" as initial loan loss reserve.

The reported balances would only relate to a subset of total loans, i.e., purchased loans. Reporting that excludes originated loans and loans acquired in pooling-of-interests would not provide users with a meaningful assessment of a company's credit risk profile, since estimated noncollectability of future payments will be presented in two different ways. These inconsistencies would only exacerbate the inconsistencies between companies, reducing the ability to compare risk management and results of operations.

Continuing to estimate future cash flows, tracked from estimates at date(s) of acquisition, and accumulate the proposed disclosures for this loan subset would not provide meaningful information. The difference in scope in this SOP and FAS 114 and the different treatment accorded originated and purchased loans would not coincide with credit risk management practices. Most readers would not understand the conceptual difference between nonaccretable yield and loan loss reserves, since the assessment of both attempt to measure the impact of many of the same risk characteristics.

For these reasons, the reporting does not appear to pass a cost/benefit test.

Effective Date and Transition: Issues 12 and 13

The effective date of the SOP as proposed is not achievable without excessive costs. We believe significant loan-by-loan analyses would be required, causing enormous systems developments or modifications. Alternatives would have to be thoroughly assessed since such accumulated estimated cash flows would provide little or no benefit other than compliance with this SOP.

We do not believe that the application would be any easier at a fiscal yearend than at an interim date, provided restatement is not required. However, we believe that a significant programming backlog will exist following the expiration of the Year 2000 systems moratoriums many companies are imposing. Thereafter, resources will be at a premium and it would be difficult to justify the enormous resultant cost and effort that this SOP would require, given that we envision little or no benefit to result.

Conclusion

In conclusion, we urge the AICPA to retract or significantly modify this proposal. Please do not hesitate to call Michael Hughey (412-234-5666) if you want to discuss any of our comments.

Sincerely,

MICHAEL R. ADCOCK, C.P.A.
THOMAS E. AHERN, C.P.A.
GARY L. CHRISTENSON, C.P.A.
LINDA S. DEVLIN, C.P.A.
RHEE ELIKER, C.P.A.
WING K. LAU, C.P.A.
DOUGLAS R. McADAM, C.P.A.
JESSIE C. POWELL, C.P.A.
JAMES L. SOREN, C.P.A.
KIRK G. STITT, C.P.A.
NORA L. TEASLEY, C.P.A.
DAVID P. TUTTLE, C.P.A.

SMB

SOREN ♦ McADAM ♦ BARTELLS
CERTIFIED PUBLIC ACCOUNTANTS, INC.

MEMBERS

ASSOCIATED REGIONAL
ACCOUNTING FIRMS (ARAF)

AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
PRIVATE COMPANIES PRACTICE SECTION

April 19, 1999

Brad Davidson, Technical Manager
Professional Standards and Services, File 2284
AICPA
1455 Pennsylvania Avenue, NW
Washington, D.C. 20004-1081

Dear Mr. Davidson:

We are pleased to comment on the AICPA's Proposed Statement of Position, *Accounting for Discounts Related to Credit Quality*. Our firm, comprised of approximately 50 professionals, provides a full range of services to small to medium size businesses.

We fully support the measurement principles as discussed on the proposed statement. However, we do not support the disclosure requirements described in paragraph 10.

First of all, it makes no sense to segregate loans based on the method of acquisition. A reader of financial statements cares little if a loan was first funded directly by the entity or was acquired from outside the organization. Accordingly, the disclosures for purchased loans should not be any different from disclosures for loans originated by the entity. If the information is considered to be useful to readers of the financial statements, then the same disclosures should be required for originated loans.

Furthermore, we do not believe that the disclosures provide any significant value, and the amount of time it would take to derive the information necessary to present the reconciliations of accretable yield and nonaccretable difference, would be essentially a complete waste of time. Accordingly, this information should not be required for internally originated or purchased loans.

We appreciate the opportunity to respond to your proposed statement.

Very truly yours,

Soren ♦ McAdam ♦ Bartells
Certified Public Accountants, Inc.

By: David P. Tuttle, C.P.A.

DPT/lmm

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April 29, 1999

Brad Davidson
Professional Standards and Services, File 2284
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue NW
Washington, DC 20004-1081

To Whom It May Concern:

The following is our response to the proposed SOP, "Accounting for Discounts Related to Credit Quality."

GENERAL COMMENTS:

We are concerned about the cost benefit relationship of the extensive footnotes. How relevant is a detailed reconciliation of accretable yields and nonaccretable differences to users of the financial statements? The time and cost involved in setting up systems to track and properly record these items for financial statement purposes and the additional cost involved in auditing additional financial statement information could be significant. Prudent businesses consider credit risk in the purchase of or investment in a loan and reflect that concern in the purchase price or cost of the loan. Periodically, the loan is evaluated for impairment, a valuation allowance, or a yield adjustment as necessary. These issues are adequately covered by existing accounting standards, notably FASB Statement No. 91, paragraphs 15 and 16 and AcSEC Practice Bulletin 6, paragraphs 13 through 15. While we appreciate the efforts of our standard setting bodies to move away from historic cost to real-time fair value accounting and reporting, We feel that this SOP goes too far. The costs out-weigh the benefits in this case.

ISSUE 1:

As it stands, the scope of the proposed SOP is appropriate with the exception of the inclusion of banking and savings institutions on whom the provisions of this SOP would be especially onerous even considering the exclusion of mortgage loans held for sale.

ISSUE 2:

It is appropriate that the proposed SOP not establish criteria in addition to FASB Statement No. 125 to distinguish between loans originated and loans purchased.

ISSUE 3:

The prohibition of the recognition of the nonaccretable difference is appropriate, conservative, and consistent with existing standards.

ISSUE 4:

The use of expected cash flows as a benchmark and the interpretation of FASB Statement No. 5 is appropriate in theory. However, as mentioned in the General Comments above, the cost involved in implementing and following the proposed SOP far out-weighs the theoretical benefits.

ISSUE 5:

The proposed SOP's treatment of positive changes in cash flows by prospectively increasing the yield over the life of the loan is appropriate.

ISSUE 6:

If we assume that the use of expected cash flows is appropriate (Issue 4), then it follows that the use of accretable yields and nonaccretable differences are necessary and that it is necessary to track the yields for future tests of impairment.

ISSUE 7:

The prohibition in paragraph 7 of the proposed SOP of investors accounting for loans, as new loans, to be refinanced or restructured after acquisition, other than through a troubled debt restructuring, is appropriate. To allow otherwise would increase volatility, earnings manipulation, and would impair comparability among entities.

ISSUE 8:

The minimum characteristics seem appropriate. However, guidance should specifically allow date clusters (monthly, quarterly, or annually, as appropriate).

ISSUE 9:

It would be helpful to point to FASB Statement No. 91 for guidance on whether an investor should accrue income. Using the argument that the SOP leaves out guidance since FASB Statement No. 118 leaves out guidance for originated loans does not make sense since the proposed SOP does not include originated loans within its scope.

ISSUE 10:

To be consistent with FASB Statement No. 114 and to disclose useful information, the creditor's policy for recognizing interest income on loans, including how cash receipts are recorded should be disclosed.

ISSUE 11:

Paragraph 9 of the proposed SOP needs to be clarified. The double negative and the circular referencing of paragraphs in related statements make paragraph 9 of the proposed SOP unduly confusing. Replacing the language in paragraph 9 with language similar to paragraph B.46. would go a long way toward clarity.

Given the adoption of the proposed SOP, in its current form, the final SOP should require that accretable yield associated with purchased loans should be segregated from that associated with originated loans.

Paragraphs 10(b) and 10(c) are the most objectionable part of the proposed SOP. We doubt the relevancy of the information to users of the financial statements considering the cost involved in recording, tracking, and disclosing the level of detail required by the proposed SOP.

ISSUE 12:

Initial application required at the beginning of the year makes the most sense. However, at least one year from the issuance of the proposed SOP should be given to give entities enough implementation time, especially if transition adjustments are required for loans acquired before the adoption date (Issue 13).

ISSUE 13:

Requiring transition adjustments would, to some extent, simplify the on-going evaluation of loans held as it would reduce the number of loan groupings. However, initial implementation of the proposed SOP would require additional time to review and adjust existing loans. Transition adjustments also promote comparability among entities. Basing the calculation of nonaccretable difference and accretable yield as of the adoption date creates a level playing field among entities. We concur with the restatement prohibition.

Respectfully,

Washington Society of CPA's

Kathleen M. Clark, CPA
Accounting, Auditing, and Review Services Committee

Rick Foster, CPA
Chairman,
Accounting, Auditing, and Review Standards Committee

WELLS FARGO BANK

343 Sansome Street
San Francisco, CA 94163

May 11, 1999

Mr. Brad Davidson, Technical Manager
American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Dear Mr. Davidson:

Re: File 2284 – Proposed Statement of Position
"Accounting for Discounts Related to Credit Quality"

Wells Fargo & Company is a bank holding company with subsidiaries providing banking, mortgage and consumer finance. We appreciate this opportunity to comment upon the AICPA's Exposure Draft (ED) on accounting for discounts related to credit quality. All references to paragraph numbers are to those in the ED, unless another source is specifically indicated.

We would like to commend the Discount Accretion Task Force for preparing such a complete document and for providing illustrations of the concepts proposed. We hope future Exposure Drafts on other topics follow this approach, particularly where complex treatments are proposed.

We believe that Practice Bulletin 6 (PB6) fails to provide the most useful information to users of financial statements, particularly for loans acquired in a business combination. While the ED is an improved discussion of the issues first addressed in PB6, we do not feel that is sufficient reason to elevate this guidance in the accounting hierarchy through issuance of an SOP. We believe that the proposal should not be issued.

Our reasons for this view are provided in more detail in the attached discussion and in the attached response to the questions on which comments are specifically requested in the ED.

Furthermore, for similar reasons, including the subsequent issuance of authoritative accounting guidance, we recommend that PB6 be withdrawn. Alternatively, in order to address the concern that loans purchased were being recorded gross with the discount added to the allowance, a one-sentence bulletin could be issued indicating that no purchase discount should be added to the allowance in such transactions. In our opinion, it is unnecessary to disrupt the time tested accounting for loans acquired in a business combination in order to address a practice encountered in a fairly limited segment of the financial services industry. The far more significant issue of the two is accounting for loans acquired in a business combination, considering that the FASB has voted that purchase accounting will be the only method for business combinations in the future. No further guidance is necessary.

However, in the event that AcSEC does not concur with the above resolution to this matter, we have provided a simplified solution in the attached discussion. That solution is based on recognizing that the 'nonaccretable difference' as defined in the ED is in fact an assessment of probable loss and, hence, should be presented and accounted for in that fashion. With that single determination, all subsequent accounting would be the same regardless of whether a loan was purchased or originated. The complex, new disclosures would be unnecessary.

Sincerely,

Les L. Qu

Les L. Quock
Senior Vice President and Controller

attachments

Attachment I
Detailed Comments on the Exposure Draft, "Accounting for Discounts Related to Credit Quality"

This Attachment contains the following sections:

- Accounting for loans purchased in a business combination
- What constitutes the loan asset
- Other matters
- A simpler alternative
- Materiality

Accounting for loans purchased in a business combination:
The banking industry makes extensive disclosures of loans, nonaccrual and impaired loans, the allowance for loan losses, charge-offs and recoveries. Investors are familiar with assessing the loan portfolio through these disclosures. The ED would result in two accounting and reporting methods, one for originated loans and one for purchased loans. The latter would implicitly have the impairment at date of purchase reflected in the net carrying value of the loan while the originated loans would continue the long standing conventions for loan accounting and reporting. Subsequent impairment with respect to purchased loans would be reflected in the allowance for loan losses. Thus purchased loans would follow two accounting models. We believe that this does not serve the best interests of users of financial statements. We believe that proposing an alternative disclosure scheme to fix the problem created by the accounting aspects of the ED does not alleviate the confusion thus created. Furthermore, this approach merely adds complexity and cost for issuers of financial statements.

The period immediately following a business combination is one of the most difficult periods for a business. All resources are devoted to the minimum essential tasks related to integrate the two, formerly independent, business enterprise. Running multiple loan systems (for the same loan types), and their subsequent integration, strains accounting resources and the ability to provide enterprise-wide MIS on the loan portfolio. To impose yet a new disclosure standard and an additional accounting method on a business in that condition is simply just not reasonable.

Loans, which exhibit substantial credit problems at the time of a business combination, would seldom remain a recorded asset of the company beyond two years following a business combination (they would either be rehabilitated, restructured or charged-off). The two-year time frame is about the period that would be needed to work through the integration issues. So by the time that resources might be available to implement a new method of accounting, the loans subject to that accounting will be gone. To repeat the point, the proposed accounting will only apply to the period of time that a company is least able to cope with it.

The (former) Wells Fargo has twice been engaged in business combinations that doubled its size each time. On average that would also double the amount of loans experiencing credit quality problems. We point this out to emphasize that the impact of the ED is no small matter. As you know, FASB has recently voted that purchase accounting will soon be the only permitted method. Hence, the ED, if adopted, will impact all business combinations in an industry where consolidation is expected to continue, giving rise to a substantial number of transactions that fall within the proposed scope. This is not an inconsequential matter.

The SEC in SAB 61 has established a superior solution to loan accounting. Investors correctly perceive the loan portfolio resulting from a business combination as the combination of the two portfolios, regardless of whether a purchase or pooling is used. Investors commonly create pro forma combined information in order to model the combined enterprise (and then quiz management on results and expectations in terms of that model). Thus, investors are better served by carrying forward the allowance of the acquired entity, which then permits the carryforward of the entire related loan accounting and disclosures in one transparent and cost effective approach. We understand that not everyone agrees that SAB 61 fully reflects the concepts of purchase accounting and, instead, feel that the concepts in the ED are more faithful to the concepts of purchase accounting. As already stated, we believe the ED's result is worse than the problem it purports to correct. Furthermore, one should not overlook the fact that the SAB 61 approach was born of necessity. Purchase accounting was being abused by recording loans net of an additional adjustment for credit quality. So the ED simply trades one problem for another. The SAB 61 approach has been tested in practice for over ten years, has to our knowledge been found workable in practice and is not a practice problem for which a solution is needed. For these reasons we do not believe the proposed SOP should be issued. If issued, SEC registrants will continue to follow SAB 61, and their auditors will give clean opinions, so why proceed with elevating this contradictory guidance in the accounting hierarchy?

What constitutes the loan asset:

Accountants, bankers and regulators have long debated what attributes should be used to identify a loan that is experiencing credit quality problems for purposes of applying various accounting treatments, for example those discussed in the ED. Some accountants believe the 'asset' should be defined as the accounting balance, the recorded investment. Others believe that is merely the accounting measurement of the asset while the asset is the contract with the borrower. We thought that SFAS 114 (as amended by SFAS 118) resolved this matter once and for all, a loan is impaired based its contractual cash flows. Measurement of the amount of impairment that needs to be recorded, when contractual obligations will not be met, is a separate element of SFAS 114.

SFAS 114, ¶8 states "A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." The transfer of such an impaired loan in a business combination does not change the cash flows. Nor does the business combination rehabilitate the borrower. However, the ED, by proposing to focus on the expected cash flows, rather than the borrower's expected ability to perform in accordance with the contractual terms of the loan agreement, presents the loan as if it were rehabilitated. That is an inappropriate outcome. We do not believe that trying to correct the inappropriate outcome with even more disclosures is a superior or cost effect approach. We are aware that some bankers do not believe that purchased impaired loans should be lumped in with those they originally underwrote, as if to say the impairment is not due to their faulty underwriting but occurred on someone else's watch. For those who hold that view and wish of their own volition to make additional disclosures, segregating purchased from originated loans not performing according to contractual terms, they may do so. There is nothing in GAAP that prohibits the issuers of financial statements from making additional disclosures, beyond the required minimum, in order to convey what they feel are important facts that help users better understand the financial statements. However, it is not necessary to both change the accounting method for purchased loans as compared to originated loans and mandate additional disclosures on everyone in order to accommodate an alternative disclosure view.

As we all learned from the last credit cycle, the matter of accounting for loans experiencing credit quality difficulties was more about disclosure then about a motivation for aggressive revenue recognition. Some issuers of financial statements pursued every conceivable avenue to reduce reported nonaccrual loans (the accepted indicator, as this period predates SFAS 114). Such approaches included the practice of charging down the loan to whatever level necessary to somehow 'cure' nonaccrual status (thus, readily the incurring income statement consequences) and ultimately selling credit-impaired loans to get them out of the disclosures (again, incurring income statement consequences).

Given that experience, we find it particularly interesting that any accounting proposal would invite accounting arbitrage by giving the buyer of an impaired loan both more favorable income recognition treatment and more favor disclosure categorization than the seller. While this result may have been reached under PB6 as well, that does not justify perpetuating it. Elevating it in the hierarchy just affirms this is the result intended by the accounting profession, so any restraint previously exhibited would not likely withstand the pressures of the next credit cycle.

Other matters:
In order to achieve the accounting of PB6 and the ED, it is necessary to assert that neither SFAS 91 nor SFAS 114 apply to purchased assets. We find this difficult to accept since this is not discussed in the scope nor background sections of either

document. SFAS 91 explicitly applies to debt securities (predominately purchased instruments). We find it especially hard to believe that AcSEC missed this point twice and did not raise it with the FASB at the time of SFAS 114. Revisiting matters now that should have been addressed in the due process leading up to establishing a FASB standard, seems inappropriate. While we are aware that FASB has not objected to exposing this matter for discussion through the SOP mechanism, that does not change the fact that we believe it is now inappropriate to assert that the definition in ¶8 of SFAS 114 ("for purposes of this Statement, a loan is a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position") does not include loans acquired by purchase.

In considering certain of our comments, AcSEC may be concerned that differentiating between purchased loans and loans acquired in a business combination accounted for as a purchase would lead to a definitional problem in distinguish one form the other. The current minutes for EITF issue 98-3 indicate they plan to discuss "a. What characteristics differentiate productive assets, as that term is defined in paragraph 3(e) of Opinion 29, from a business, as that term is used in paragraph 1 of Opinion 16?" Once that is decided, it should be relatively easy to distinguish a purchase of a group of financial assets from a business combination.

SFAS 118 was issued for the purpose of removing the complex revenue recognition guidance proposed by SFAS 114. The ED leverages off the removed guidance and reinstates a similar approach for the population of loans included in its scope. We do not support the ED's piecemeal reapplication of these burdensome practices previously resolved by due process.

As complex as the Appendix A illustration is, it over simplifies the implementation of the proposed accounting. All loan systems are designed to account for the loan according to contractual terms. Interest income and interest receivable are accrued at the contractual rate upon the passage of time (which is linked to customer billing). The level payment loan selected for the illustration obscures this point. Likewise, a loan most typically is not recorded (grossed up) to reflect contractual interest expected but not yet receivable, unless it is documented in that fashion (note that leases are outside the scope of the ED), see the explanation of discount basis loans in ¶6.17(b) of the *Banks and Savings Institutions Audit and Accounting Guide*. The appendix adopts a convention of recording the 'loan' amount that includes amounts that are not yet contractually due. This may be fine for illustrative purposes. However, the illustration should be footnoted to indicate that the ED itself does not actually require that. Since the amount of accretable yield is not to be displayed in the balance sheet, ¶4, any manipulation that results in the same initial net recorded investment should be permitted (and should be acknowledged). Many loan systems have provisions for deferring and amortizing one "unearned" amount, primarily as a result of SFAS 91's requirement for net loan fee and cost amortization. Hence, the expected future cash flows in excess of remaining unpaid principal (face) could be netted against the accretable yield (unearned income) so that only the incremental yield over the contractual interest rate would need to be amortized. The remaining yield would be recognized as accrued by the loans system with the passage of time.

A simpler alternative:
As our previous comments indicate, we do not support the accounting described in the ED nor in PB6. However, if AcSEC nonetheless decides to proceed in that direction, we believe that the approach could be greatly simplified, as described below:

1. An assessment at purchase, as described in the ED, would be performed in order to determine the accretable discount ('accretable yield') and the nonaccretable discount ('nonaccretable difference').
2. The accretable discount would be amortized as interest income as permitted by SFAS 91 ¶18.c. It would not be periodically reassessed in relationship to expected future cash flows.
3. Since the nonaccretable discount represents the purchaser's assessment of probable loss at the date of purchase, the nonaccretable discount represents an allowance for credit loss and should be accounted for in that fashion. Hence, it would be displayed as 'initial allowance for credit losses at date of purchase' and segregated from the 'general' allowance for loan losses (either as a separate caption on the balance sheet or as a segregated portion of the allowance for loan losses). It would be available only for charge-offs from the loan population acquired in a specific purchase.
4. All accounting subsequent to date of purchase follows existing GAAP. A reduction in expected cash flows from those estimated at purchase would define a nonperforming loan (nonaccrual for bank regulatory and industry practice).

- Any subsequent increase in probable loss would be accounted for in the general allowance in accordance with existing GAAP (e.g., SFAS 114 for loans within its scope). Since the 'initial allowance for credit losses at date of purchase' is separately stated, it facilitates the assessment of whether total credit loss has been adequately captured in the ongoing process, in contrast to the ED.
- Any subsequent improvement in cash flows (reduction of probable loss) would be accounted for by reduction of the allowances as under current GAAP (first the general allowance if any was provided subsequent to purchase and then the initial allowance).
- (As previously stated) the accretable discount would be amortized as loan interest income in accordance with SFAS 91, that is, it would not be periodically reassessed in relationship to expected future cash flows. In practice, the accretable discount would be combined (netted) with the portion of contract receivable in

excess of the loan's remaining face (principal) amount and would be amortized over the life of the loan as a component of interest income. We believe most loan systems could accommodate the accounting in this fashion. For this reason, and others, no disclosure of the accretable discount should be required. The loan system would then account for the loan according to contractual terms and accrue and record interest income. The net (combination) of amortization and accrued contractual interest in each period would sufficiently approximate the interest income contemplated in the ED. For floating rate loans, as provided for in SFAS 91, the contractual receivable at time of purchase would be computed based on the rate in effect at purchase date. Any increase or decrease would be recognized as part of the contractual accrual discussed above. Hence, no additional computations would be needed for floating rate loans. Loan disclosures would be in accordance with existing GAAP and practice (e.g., Guide 3). There would be no need for the disclosures proposed by the ED. All that would be needed is a reconciliation of the changes during the period in the 'initial allowance for credit losses at date of purchase' and the net recorded investment in the purchased loans at period end. For those issuers of financial statements who conduct numerous small purchases, the disclosures would be aggregated for purchased loans but the underlying accounting would remain purchase-by-purchase.

We believe the above proposal has numerous advantages over the ED:

- It is more in accordance with existing GAAP for originated loans, and thus does not introduce new interpretations of the accounting literature to support its conclusions.
- It is less complex than the ED is.
- For both reasons above, it is more understandable to users of financial statements.
- It would remove the preferential accounting for purchased loans (or eliminate the accounting and reporting arbitrage compared with originated loans).
- Is more cost effective for issuers of financial statements.
- Addresses the key practice concern, which caused the project that resulted in the ED, that is, the initial recording of loans at date of purchase.

Nonetheless, we do not believe even the above simplified approach should be applicable to business combinations accounted for as a purchase. The former Norwest and the "new" Wells Fargo had and continue a strategy of small acquisitions. We do not feel that that either the accounting proposed by the ED nor the alternative proposed above adds information value for business combination accounting. Continuing the current practice of showing the amount, by which the general allowance was increased, as a result of business combinations, is sufficient.

Materiality:

While we understand that the provisions of the ED do not apply to immaterial items, that should not be a justification for undue complexity in accounting standards. The accounting profession in conjunction with the banking industry has made substantial progress in convincing the regulators to follow GAAP in their regulatory reports. The reduction in regulatory accounting practices resulted in a burden reduction for preparers of regulatory reports. Nonetheless, each individual bank (or savings institution) and specified nonbank entities owned by a bank holding company must produce a separate set of regulatory statements (e.g., Call Report). The regulators will insist that GAAP be applied to each and materiality will be measured in terms of the individual report. Thus, the impact of complexity in GAAP is not properly assessed if viewed only in context of the audited financial statements, which are normally produced at the consolidated holding company level.

Attachment II
"Accounting for Discounts Related to Credit Quality."
Comments specifically requested

Note: As stated in the cover letter, Wells Fargo does not support issuing the SOP as proposed. Answering the following questions individually should not be construed as expressing a different opinion.

- Issue 1 – Like PB 6, the scope of the proposed SOP includes loans and debt securities. The definition of loan is that in SFAS 114, but the scope of the proposed SOP excludes loans measured at fair value through earnings, loans acquired in a business combination accounted for as a pooling of interests, mortgage loans for sale, leases, and loans held by liquidating banks. Is this scope appropriate? If not, how should the scope be amended and why?

  Response: The scope should not include loans acquired in a purchase business combination. The ED expands the concepts of SFAS 114 beyond the scope of SFAS 114, which excluded large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. Considerable effort went into determining the scope of that guidance. Expanding the concepts of SFAS 114 beyond its stated scope through an SOP is inappropriate.

  In order to address the concern that loans purchased outside of a business combination have been recorded gross with the discount added to the allowance, a one-sentence bulletin could be issued indicating that no purchase discount should be added to the allowance.

- Issue 2 – The criteria in SFAS 125 make it unnecessary to establish criteria that distinguish between loans originated and loans purchased. Is this appropriate? If not, what criteria should be established?

  Response: Yes, SFAS 125 appropriately defines when a loan is purchased. However, we believe that SFAS implicitly excludes loans obtained in a business combination. Therefore, the ED should not include loans obtained in a business combination.

- Issue 3 – For loans in the scope of the proposed SOP, paragraph 4 of the proposed SOP would prohibit investors from (a) recognizing – as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk – any of the excess of contractual payments receivable over expected future cash flows (nonaccretable difference) or, (b) displaying such excess in the balance sheet. Is this prohibition appropriate? If not, how is the investor justified in recognizing – as an adjustment of yield, a loss accrual, or a valuation allowance for the loan for credit risk – losses that were not incurred by the investor?

Response: With respect to revenue recognition, we believe that all impaired loans should be accounted for the same way (essentially, cash method or cost recovery) and that loans that are not impaired should be accounted for in accordance with SFAS 91, including ¶ 17, without regard to whether they were purchased or originated*.
For loans acquired in a business combination, we believe that the allowance should be carried over as further described in the SEC's SAB 61. The purpose of the allowance focuses on adjusting the loan contract receivable so that the net carrying value is properly stated to reflect probable loss inherent in the contracts receivable. The focus is the borrower's anticipated ability to perform. Since that is not changed as a result of a transfer of receivables between buyer and seller, it follows that the impairment has not changed. As indicated by the SEC, when a business combination occurs, it is to be assumed that the allowance was adequate. While 'adequate' may fall within a range of acceptable estimates, those estimates should not be changed unless the allowance is unreasonable in which case the predecessor's financial statements need restatement or in cases where the acquirer plans to manage the assets differently.
When loans are acquired outside of a business combination, it is not feasible to follow the above approach. We believe it is sufficient to record such purchased loans at their purchase price entirely outside of the allowance (see the last paragraph of our response to Issue 1). However, if the type of analysis proposed by the ED is required, then the impairment aspect (nonaccretable difference) should be reflected in the allowance. See Attachment I for a more complete discussion of a simplified approach to this matter.
*The same revenue recognition methods should be applied as are applied for originated loans (many consumer loans remain on accrual, until a prescribed period of delinquency occurs, at which time the loan is entirely charged off. Premiums and discounts are amortized on a pool basis).

- Issue 4 – The proposed SOP would establish the investor's estimate of undiscounted expected future principal and interest cash flows as a benchmark for yield and impairment measurements. This approach recognizes that the investor acquired the loan with the expectation that all remaining contractual payments would not be received. This approach interprets SFAS 5 to focus impairment on whether it is probable that the investor will be unable to *collect all of the investor's originally expected future cash flows* rather than *all amounts due according to the contractual terms of the receivable.* Are the expected-cash-flows benchmark and the interpretation of SFAS 5 appropriate? If not, how should yields and impairments be measured and why?

Response: The proposed accounting is overly complex and should not be mandated. As permitted by SFAS 118, ¶6.g., existing methods of accounting should be used for loans that are not performing, or are expected not to perform, according to their contractual terms.

- Issue 5 – The proposed SOP would preserve PB 6's treatment of positive changes in cash flows after acquisition. Such changes would be recognized prospectively by an increase in yield over the remaining life of the loan. Is this approach appropriate? If not, how should an investor recognize positive changes in cash flows and why?

  Response: Prospective recognition should be used for a change in estimate.

- Issue 6 – The proposed SOP requires that the new, higher yield on a loan (established, for example, by a significant increase in expected future cash flows) must be used as the effective interest rate in any later test for impairment. Please comment on the appropriateness of this provision.

  Response: FAS 114 footnote 3 would suggest that impairment is always based on the discount rate contemplated at purchase. This issue highlights to complexity of the ED. Carving out special treatment for purchased loans creates confusion. Since paragraphs B. 39 and 40 do not explain why they disagree with the FASB's views, above, it would seem inappropriate to depart from that guidance, even though some might believe the ED's approach is logically consistent.

- Issue 7 – The proposed SOP prohibits investors from accounting for, as new loans, loans within the proposed SOP's scope that are refinanced or restructured after acquisition, other than through a troubled debt restructuring. Is this appropriate? Why or why not? If not, how should non-troubled refinancings and restructurings be addressed?

  Response: This approach seems appropriate where the borrower remains the same. The same situation occurs when loans previously on cost recovery (nonaccrual) are returned to accrual. While it may be frustrating that an ever-decreasing discount is spread over a newly negotiated loan, with an appropriate contractual interest rate for the rehabilitated borrower, this is essentially the logical outcome of the accounting conventions. The accounting should not permit income recognition merely from paper shuffling. However, Wells Fargo has encountered situations where the borrower (generally in corporate form) remains the borrower in form only. In fact the borrower's stock is obtained by unrelated interests who either recapitalize the borrower or otherwise enhance the credit quality. After the change in ownership the loan may be restructured in a nontroubled debt restructuring. In these case we believe there is a new borrower and the unearned income from the old loan is not carried forward. Rather, it is recognized into income as befits the end of the accounting cycle. You might consider starting paragraph 7 with "Except in the case where the borrower has been recapitalized,..."

- Issue 8 – The proposed SOP allows entities to aggregate loans that have common risk characteristics for purposes of recognition and measurement. The common risk characteristics should always include financial-asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Are these minimum risk characteristics appropriate? If not, what criteria should govern aggregation of loans?

  Response: This long list of criteria does not appear in the draft statement nor background materials, so this question is confusing as to context and background. Certainly this long list of distinctions is excessive, particularly when combined with the word "always." It appears that every possible distinction that might be used in assessing a highly heterogeneous mortgage loan servicing portfolio for impairment has been projected onto every loan type and purchase. The proposed guidance is not appropriate.
  Why would origination date be of any significance for an open ended revolving consumer credit loan? Why would geographical location be of significance to a domestic loan other than one secured by real estate? The last sentence of ¶B.30 (To apply the provisions of this SOP, the investor may need to segregate loans purchased together into multiple groups based on payment history an other indications of relative credit risk [delete 'each loan's']) is far superior and should be moved into ¶8.

- Issue 9 – PB 6 addressed whether an investor should accrue income. The proposed SOP eliminates such guidance for loans within its scope because such guidance does not exist for originated loans. Is it appropriate to eliminate PB 6's income recognition guidance? If not, what criteria should determine whether the investor should accrue income and why?

  Response: We do not believe guidance should be given on how to apply nonaccrual accounting for a special class of loans, those purchased. Since SFAS 114 does not specify an accounting method and subsequent AICPA documents, such as the *Banks* *and Savings Institutions Guide*, have deleted such guidance as a result of FASB's conclusions, it seems inappropriate to attempt to address those matters in this limited context. However, leaving the ED as is gives the impression that guidance has been given on when to accrue income, which is whenever excepted future cash flows exceed the current recorded investment. A shortcoming of the entire approach in the ED is that it gives more favorable accounting treatment to purchased loans then for originated loans that are not expected to perform according to contractual terms. This is misleading to users of financial statements, since current accounting conventions implicitly assume that if the borrower is not meeting contractual terms, then the lender can not estimate the future cash flows with enough certainty to base revenue recognition on those assumptions. However estimating asset impairment is always a necessity. Therefore, current practice is binary; a loan is either on (full) accrual or it is on 'nonaccrual.' There is no partial accrual. We believe favorable treatment is not necessary for purchased loans, beyond that provided in ¶3 of SFAS 114. Since a purchaser uses the effective rate at purchase when applying the disclosure provisions of SFAS 114, the purchaser can enter into a troubled debt restructuring with the borrower, reduce the face amount of the loan to what can be expected to be repaid and still achieve the yield that was excepted at time of purchase. Thus, the restructured contractual rate can be set such that the restructured loan is returned to accrual and removed from the impaired loan disclosures the following year. Where a lender is not willing to restructure the loan but rather holds the borrower to the original contractual terms, despite contractual delinquency, no special accounting or disclosure should be provided.

- Issue 10 – SFAS 114, as amended, requires disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded. Should the final SOP require such disclosures for loans that are within the scope of this SOP but not within the scope of SFAS 114?

  Response: Narrative policy disclosures are appropriate. Quantitative disclosures are not appropriate.

- Issue 11 – Entities would disclose the following separately for loans accounted for as debt securities and loans not accounted for as debt securities: a) carrying amount at the beginning and end of the period; b) amount of accretable yield at the beginning and end of the period reconciled for changes; c) amount of nonaccretable difference at the beginning and end of the period reconciled for changes; d) amount of loss accruals and reversals made for loans not accounted for as debt securities during the income statement period. Are these disclosures appropriate for loans within the scope of the proposed SOP? If not, how should the disclosures be changed and why? Should the final SOP require that the accretable yield associated with purchased loans be segregated from the accretable yield associated with originated loans?

Response: The disclosures are overly complex and should not be required. The disclosures are confusing to investors because of their complexity and costly to issuers of financial statements. See attachment I for an alternative approach to the matters addressed by the ED.

- Issue 12 – The proposed SOP would be effective for financial statements issued for fiscal years beginning after June 15, 2000. Initial application would be required as of the beginning of the investor's fiscal year. Should adoption instead be required as of the end of a fiscal year, without restatement of the results of operations for the preceding twelve months? Why?

  Response: Adoption at the beginning of the fiscal year is appropriate.

  Issue 13 – The proposed SOP would apply to loans acquired before the adoption date and would require transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would be based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than the date the investor acquired the loan. Please comment on the appropriateness of the required transition adjustments. Alternatively, should the proposed SOP not be applied to loans acquired before the adoption date and, if so, why?

  Response: The SOP should be applied only to loans acquired after the effective date. There is a significant information burden as a result of the proposed accounting and disclosures, as has been stated throughout our comments. It will be difficult enough to apply this to newly acquired loans. Going back to previously acquired loans, such in a business combination, is simply prohibitive to those entities in that situation.

April 29, 1999

Brad Davidson
Technical Manager
Professional Standards and Services, File 2284
AICPA
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Re: December 31, 1998 Exposure Draft of a Proposed Statement of Position – Accounting for Discounts Related to Credit Quality

Dear Mr. Davidson:

We are pleased to submit our comments to the above Proposed Statement of Position on behalf of the New York State Society of Certified Public Accountants. The comments were prepared by the Financial Accounting Standards Committee and the Banking Committee of the Society.

Issue 1: We believe the scope, as set forth in paragraph 3 of the proposed SOP is appropriate. However, we suggest that the final SOP clarify how the "common risk characteristics" criteria, as discussed in paragraph 8, should be applied to portfolios of small homogeneous loans (such as credit card and automobile loans), since several of the criteria (for example, origination date and term) identified in the glossary are not relevant to such loans.

Issue 2: We believe originated loans should be excluded from the scope of the SOP since (a) the origination of loans is fundamentally different from the purchase of loans and (b) adequate accounting guidance already exists for originated loans.

Issue 3: We believe investors should not be prohibited from displaying either the nonaccretable difference or the accretable difference in the balance sheet. Our reasons are these:

- As to the nonaccretable difference, such a prohibition is at variance with paragraph 88 of APB Opinion 16, which states that purchased receivables should be initially recorded at the "present values of amounts to be received, determined at current interest rates, less *allowances* for uncollectibility and collection costs, if necessary (emphasis added)". And, we are unaware of any divergence in practice from that provision.

- Users of financial statements (particularly analysts and regulators) are accustomed to finding valuation allowances (which would include the nonaccretable difference) in the balance sheet, and prohibiting the display of the nonaccretable difference in the balance sheet could cause unnecessary confusion and complexities in the calculation of key financial ratios.

- Since notes to financial statements are considered to be an integral part of the financial statements them- selves, it is usually unimportant whether a particular amount is displayed in the body of the financial statements or in the notes. Moreover, until now, generally accepted accounting principles (GAAP), with limited exceptions, have not specified the display of amounts, including valuation allowances. We believe the proposed SOP does not provide compelling justification as to why the nonaccretable difference is such an exception.

- As to the accretable difference, paragraphs 16 and 20 of APB Opinion 21 allow the accretable yield to be displayed in the balance sheet.

Nonetheless, if the final SOP prohibits investors from displaying either the nonaccretable difference or the accretable difference in the balance sheet, then we would urge that the final SOP also provide justification for that treatment which, as we pointed out, would violate existing accounting standards and represent a change in practice where no need for a change in practice has been demonstrated.

Issue 4: We believe the calculation of the nonaccretable difference using expected cash flow benchmarks (in effect, an interpretation of FASB No. 5) is appropriate.

Issue 5: We believe the treatment of positive changes in cash flows of purchased loans subsequent to their acquisition should be viewed as a prospective adjustment of yield, and that such treatment is consistent with existing GAAP and practice. However, we suggest that the conclusions section of the final SOP should clarify to what extent, if any, the accounting for "loans" and "debt" differs under the SOP, since the proposed SOP, at times, refers to "loans", while at other times, it refers to "debt".

Issue 6: We believe the use of a new, higher effective rate for determining future impairments is theoretically preferable. However, we question whether the benefits of using that approach would outweigh the additional yield-tracking costs involved. We, therefore, suggest that this matter be addressed in the final SOP.

Issue 7: We believe investors should be prohibited from treating, as new loans, purchased loans that are subsequently refinanced or restructured. This treatment, however, raises an issue of accounting symmetry between investors and debtors with respect to a material modification of such loans and, while we do not necessarily believe there needs to be symmetry between investors and debtors in certain instances, we suggest that the final SOP at least address the symmetry issue. (See EITF 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments".

Issue 8: Apart from our comments to Issue 1, we generally support the common risk characteristics criteria discussed in paragraph 8 of the proposed SOP. We are unconvinced, however, that all of the characteristics identified in the glossary need to be met in all cases. Rather, we suggest that the final SOP's definition use less restrictive language such as "...common risk characteristics include, *for example...*".

Issues 9 and 10: We believe the conclusion to eliminate the Practice Bulletin 6 income recognition guidance is appropriate. Furthermore, we believe investors should be required to disclose their accounting policy relating to the recognition of interest income of impaired loans that are within the scope of the SOP, but not the scope of FASB Statement No. 114.

Issue 11: We generally believe the individual disclosures set forth in paragraphs 9 and 10 of the proposed SOP are appropriate. However, we question whether, in the aggregate, all of them are necessary. Moreover, it is unclear to us which group of users have asked for this level of detailed disclosures. We would, therefore, urge the AICPA to field-test these disclosures before issuing a final SOP to ensure that the benefits of all of these disclosures outweigh the cost of making them.

Issues 12 and 13: We believe all provisions of the final SOP should be applied to loans that are purchased after an investor adopts the final SOP. However, we believe an investor should be permitted, but not required, to apply the provisions of the final SOP to loans that were purchased prior to the adoption of the final SOP.

General Comment: We commend the AICPA on the quality and completeness of the implementation guidance materials provided in the exposure draft and, although we have no reason to believe the AICPA will do otherwise, we urge it to include all of those materials in the final SOP.

We hope these comments have been helpful. If you wish to pursue these items further, please let us know, and we will request that a member of the Committee contact you.

Very truly yours,

John J. O'Leary, CPA
Chair, financial Accounting Standards Committee

Kenneth W. Bosin, CPA
Chair, Banking Committee

James A. Woehlke, CPA
Director, Technical Services