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August 5, 2019

Shayne Kuhaneck, Acting Technical Director
Financial Accounting Standards Board
401 Meritt 7
PO Box 5116
Norwalk, CT 06856-5116

Via Email to director@fasb.org

Re: File Reference No 2019-710

Dear Mr. Kuhaneck:

Grant Thornton LLP appreciates the opportunity to comment on Proposed Accounting Standards Update, *Codification Improvements to Topic 326, Financial Instruments – Credit Losses*.

We also appreciate the continued efforts of the FASB to meaningfully engage stakeholders during the implementation of Topic 326 (the CECL model) through the Transition Resource Group for Credit Losses, roundtables, and additional standard setting.

We do not believe that entities should be allowed to recognize negative allowances that would result in recognizing amounts in income (via a negative credit loss expense) that are not related to improvements in expected credit losses. As discussed below, we believe that allowing entities to recognize negative allowances that would result in recognizing amounts in income that are not related to improvements in expected credit losses is inconsistent with the conceptual basis for the CECL model.

Our answers to selected questions for respondents follow.

General Questions

Question 1: Should other changes be made that are directly or indirectly related to amendments in this proposed Update?

We have not identified any other necessary changes to the amendments in this proposed Update. However, we believe that there is no distinction between PCD and non-PCD assets subsequent to initial recognition, and so we would encourage the FASB to consider applying any subsequent changes to the proposed guidance on negative allowances recognized on purchased credit-deteriorated (PCD) assets to negative allowances recognized on non-PCD financial assets as well. Please see the Appendix in this document for an example of one such issue that the FASB might consider.

Issue 1: Negative Allowance for PCD Assets

Question 3: Should an entity be permitted to record a negative allowance (basis recovery) when measuring the allowance for credit losses for purchased financial assets with credit deterioration?

We believe an entity should be allowed to recognize a negative allowance on PCD assets provided recognition of the negative allowance does not result in the entity recognizing amounts in income (via a negative credit loss expense) that are not related to improvements in expected credit losses.

The proposed guidance on recognizing a negative allowance on previously charged-off financial assets may result in an entity recognizing amounts in income (via a negative credit loss expense) that are not related to improvements in expected credit losses on the previously charged-off financial assets. In our view, this would be inconsistent with the conceptual basis for the CECL model. For entities that utilize a non-discounted cash flow (non-DCF) method to estimate their allowance for credit losses, the CECL model explicitly states that it does not address the recognition of interest income, other than the initial determination of the noncredit discount on PCD assets. After initial recognition, interest income is determined by using the effective interest method. Accordingly, the CECL model's only impact on the income statement after initial recognition should be as a result of changes in expected credit losses. However, as illustrated in the Appendix to this letter, we believe the proposed guidance may be interpreted in such a way as to result in entities recognizing income that is not the result of a change in expected credit losses. In fact, under this interpretation, a practical result of applying the proposed guidance may be to accelerate the accretion of any noncredit discount on a PCD asset into income.

While this issue seems to be most prominent within the context of PCD assets, we believe the issue also exists for non-PCD assets. We have attempted to illustrate this issue in the Appendix for both PCD and non-PCD assets.

Question 4: Should a negative allowance (basis recovery) for PCD assets be limited to the amortized cost basis previously written off and expected to be written off by the entity? If not, please explain why and what changes should be made instead.

As noted in our response to Question 3, we do not believe that entities should recognize amounts in income (via a negative credit loss expense) that are not related to improvements in expected credit losses on previously charged-off financial assets. However, we believe the proposed guidance may be interpreted in such a way as to allow entities to recognize income that is not the result of a change in expected credit losses. We believe this is because of ambiguity with regard to the meaning of the following sentence in proposed paragraph 326-20-30-13A:

> *An entity shall not include recoveries or expected recoveries of the unamortized noncredit discount or premium in the allowance for credit losses.*

We have two observations regarding this sentence in the proposed guidance:

First, we feel that the intended meaning of this sentence is unclear because it can be interpreted in two ways:

- *View 1*: An entity may recognize as recoveries only the amortized cost basis previously written-off or expected to be written-off (since the amortized cost basis is already adjusted for unamortized noncredit discounts or premiums).
- *View 2*: An entity may not recognize a negative allowance that results in an increase in income because that would, in effect, accelerate the recognition of a noncredit discount.

We believe View 2 is the appropriate interpretation of this sentence. We have illustrated the application of Views 1 and 2 in the attached Appendix. Additionally, due to the lack of clarity regarding the interpretation of this sentence, we would ask the Board to include an example clarifying the principle articulated in paragraph 326-20-30-13A.

With regard to how entities should comply with View 2, we believe entities may take different approaches to avoid recognizing amounts in income (via a negative credit loss expense) that are not related to improvements in expected credit losses on previously charged-off financial assets. For example, entities that utilize a method other than a DCF method to estimate the allowance for credit losses may limit any negative allowance to the pre-write-off net carrying amount. In contrast, entities that utilize a DCF method may not have to observe such a limit.

Second, we believe that an entity would need to apply the proposed guidance at the individual financial-asset level. This is because the amount of an unamortized noncredit discount or premium is associated with an individual financial asset and not a portfolio of financial assets. We believe the FASB should amend the proposed guidance to make this clear.

Question 5: Should the recognition of a negative allowance (basis recovery) be extended to available-for-sale (AFS) debt securities?

We do not believe an entity should be permitted to recognize a negative allowance when measuring the allowance for credit losses on AFS debt securities. In our view, this would violate the general recognition principle for AFS debt securities in which unrealized gains are recorded as a component of other comprehensive income.

Issue 2: Transition Relief for TDRs

Question 6: Should an entity be permitted to adjust the effective interest rate on existing TDRs using prepayment assumptions on the date of adoption of Topic 326 rather than the prepayment assumptions in effect immediately before the restructuring?

We agree that entities should be permitted to adjust the effective interest rate on existing TDRs using prepayment assumptions on the date of adoption of Topic 326.

Topic 4: Financial Assets Secured by Collateral Maintenance Provisions

Question 8: Do you support the proposed amendments to clarify the application of the collateral maintenance practical expedient in accordance with paragraph 326-20-35-6?

We agree with the proposed amendments to paragraph ASC 326-20-35-6 to clarify the application of the collateral maintenance practical expedient.

Transition and Effective Date

Question 10: Do you support the proposed transition method and transition disclosures when adopting the proposed amendments?

We agree with the transition method and the transition disclosure requirements for the adoption of the amendments in the proposed Update.

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We would be pleased to discuss our comments with you. If you have any questions, please contact Graham Dyer, Partner, 312.602.8107, Graham.Dyer@us.gt.com, or Rahul Gupta, Partner, 312.602.8084, Rahul.Gupta@us.gt.com.

Sincerely,

/s/ Grant Thornton LLP

Appendix

Negative allowances and recognition of income unrelated to improvements in expected cash flows

The examples below are simplified examples intended to illustrate how applying the proposed guidance on the recognition of negative allowances on both PCD and non-PCD assets might result in entities recognizing amounts in income (via a negative credit loss expense) that are not related to improvements in expected credit losses on financial assets previously written-off.

PCD assets

Assume that Entity A has a portfolio of PCD assets with the following amounts comprising its net carrying amount:

Balances as of 12/31/X1		
Par	$	10,000,000
Noncredit discount		(2,000,000)
Amortized cost		8,000,000
Allowance for credit losses		(3,000,000)
Net carrying amount		5,000,000

Entity A expects to collect a total of $7,000,000 on the portfolio of PCD assets. The portfolio's remaining contractual term is three years. Entity A estimates its allowance for credit losses using a non-DCF method.

On 1/1/X2, all of the financial assets in the portfolio are charged-off by Entity A pursuant to its charge-off policy. Entity A, however, still expects to collect $7,000,000 on the portfolio of PCD assets (that is, there has been no change in expected credit losses on the portfolio of financial assets).

As described in our response to Question 4, we have identified two views in how entities might apply the proposed guidance.

<u>View 1</u> – Recognize recoveries up to the amortized cost basis written-off.

Entity A records the following two journal entries on 1/1/X2:

Entry #1 - Charge-off portfolio of PCD assets		
Allowance for credit losses	3,000,000	
Noncredit discount	2,000,000	
Credit loss expense	5,000,000	
Financial assets at par		10,000,000

Entry #2 - Recognize negative ACL		
Allowance for credit losses	7,000,000	
Credit loss expense		7,000,000

The net result of these two entries is to recognize into income $2,000,000 on 1/1/X2 (in effect accelerating the accretion of the full amount of the noncredit discount), even though there was no change in expected credit losses on the portfolio of financial assets.

<u>View 2</u> – Recognize recoveries only up to the amount that would not result in an increase in income as a result of the write-off. In this case, that is the pre-write-off net carrying amount of the PCD asset.

Entity A records the following two journal entries on 1/1/X2:

Entry #1 - Charge-off portfolio of PCD assets		
Allowance for credit losses	3,000,000	
Noncredit discount	2,000,000	
Credit loss expense	5,000,000	
Financial assets at par		10,000,000

Entry #2 (View 2) - Recognize negative ACL		
Allowance for credit losses	5,000,000	
Credit loss expense		5,000,000

<u>View 1 analysis</u>

An entity may recognize amounts in income (via a negative credit loss expense) that are not related to improvements in expected credit losses on financial assets previously written-off as the result of the convergence of several elements of the CECL model:

- Discounts on financial assets measured at amortized cost are amortized into interest income by applying the interest method to the financial asset at the financial asset's effective interest rate.

- An entity may utilize an approach to estimate the allowance for credit losses (including a negative allowance) that does not consider the financial asset's effective interest rate.
- Entities employ a variety of charge-off policies that may result in charging-off amounts the entity expects to collect, which the CECL model does not prohibit.

As a result of these combined factors, Entity A recognizes $2,000,000 of income as a negative credit loss expense, effectively amortizing the full noncredit discount, as a result of charging-off a portfolio of financial assets, with no change in expected credit losses. We believe this is inconsistent with the conceptual basis for the CECL model.

View 2 analysis

We believe the outcome of View 2—that is, recognizing the negative allowance at the same net carrying amount as the financial assets immediately prior to the write-off, which would prevent the recognition of income as a direct result of a write-off—is consistent with the conceptual basis for the CECL model.

Non-PCD assets

We believe that View 1 is how entities would apply the recovery guidance in ASC 326-20-30-1 to non-PCD assets. This application may result in income recognition in a period in which a charge-off occurs that is not associated with a change in expected credit losses. This may arise when the period of charge-off is different from the period in which a credit loss allowance was established via a credit loss expense. While it is likely that the level of any unamortized discount and allowance for credit loss on non-PCD assets would be proportionately smaller when compared to PCD assets, this issue could exist nonetheless.

To illustrate, assume that Entity A acquires a financial asset on 12/31/X1. The financial asset has a par amount of $10M, expected credit losses of $0.5M, and Entity A pays $9.5M to acquire the asset. The financial asset does not share risk characteristics with Entity A's other financial assets and is therefore not pooled for purposes of estimating the ACL.

Balances as of 12/31/X1	
Par	$ 10,000,000
Purchase Discount	(500,000)
Amortized cost	9,500,000
Allowance for credit losses	(500,000)
Net carrying amount	9,000,000

Accordingly, Entity A would recognize a $0.5M credit loss expense upon initial recognition of the financial asset.

On 3/31/X2 (a financial reporting date for Entity A), the financial asset meets Entity A's criteria for charge-off, although Entity A still expects credit losses of $0.5M (for simplicity's sake, assume that the balances associated with the financial asset on 3/31/X2 are the same as those at 12/31/X1).

Entity A would then make the following entries under View 1:

Entry #1 - Charge-off portfolio of PCD assets		
Allowance for credit losses	500,000	
Purchase Discount	500,000	
Credit loss expense	9,000,000	
Financial assets at par		10,000,000

Entry #2 (View 1) - Recognize negative ACL		
Allowance for credit losses	9,500,000	
Credit loss expense		9,500,000

The result of these two entries is for Entity A to recognize $0.5M into income in the quarter ended 3/31/X2, even though there was no change in expected credit losses. This is because the expense recognized to establish the ACL on the financial asset was recognized in an earlier period.