



October 25, 2013

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Financial Accounting Standards Board
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File Reference: No. 2013-290, Proposed Accounting Standards Update, *Insurance Contracts (Topic 834)*

Dear FASB Board Members and Staff:

The PNC Financial Services Group, Inc. ("PNC" or "we") appreciates the opportunity to comment on the Proposed Accounting Standards Update, *Insurance Contracts (Topic 834)*, (the "Proposed ASU") which solicits feedback on the Financial Accounting Standards Board's ("FASB's") proposal to establish a common set of principles addressing the recognition, measurement, presentation and disclosure of insurance contracts issued and reinsurance contracts held by a reporting entity (including non-insurance entities).

Summary

While we agree that improvements can be made to the current long-duration insurance contract model (i.e., most life, annuity and long-term health contracts) under U.S. generally accepted accounting principles (GAAP), we do not agree with a proposal which attempts to redefine a significant subset of banking products as insurance without thoroughly considering the funding mechanics of these instruments or the impact of other related standards on measurement. Moreover, we are not aware of any demand from users of our financial statements to improve the accounting for these types of financial guarantees. The current accounting model is both operational and well-understood.

Most of the banking products scoped into the Proposed ASU are credit-risk products including financial guarantees of debt, stand-by letters of credit (LOC) and mortgage guarantees. We believe that the principle risk associated with these products is clearly a component of financial risk, not insurance risk. Other products scoped into the Proposed ASU include representations and warranties associated with the sale of financial assets and a broad range of indemnities. These products are not traditionally viewed from a business perspective or underwritten as insurance contracts, and their characterization as insurance would only confuse users of our financial statements.

We believe the FASB should consider a targeted approach to improving the accounting for insurance contracts by focusing its efforts on the accounting for long-duration contracts.

Credit Risk is Not Insurance Risk

The proposed framework for scoping in many of these banking products is based on an assertion that credit risk is equivalent to insurance risk. Specifically, the Proposed ASU asserts that credit (or default) risk is fortuitous (i.e., unpredictable or unanticipated) exposing the credit holder to the possibility of an adverse event which creates uncertainty about the amount of net cash flows from a contract¹. In other words, the Proposed ASU asserts that credit risk is a risk that cannot be anticipated, controlled, mitigated or managed similar to the risk of flood damage to a house or collision damage to a car.

We do not believe that credit risk is the same as insurance risk. Credit risk (or default risk) has been and remains a component of financial risk, as do other risks such as market risk, liquidity risk and operational risk. Financial risk is generally defined as the risk of loss an investor assumes in a financial investment. Moreover, unlike insurance risk, credit risk can be mitigated by restructuring payment terms, seizing and selling collateral pledged within the contract and/or by requiring additional collateral. We believe users of our financial statements view both credit risk and financial risk in the same manner.

It appears that the Proposed ASU attempts to redefine financial risk² to a narrower subset, something akin to market risk, in order to recharacterize credit risk as insurance risk. In our opinion, this is a delineation established merely to satisfy the objective of scoping in any financial product which transfers the risk of loss from one party to another. We believe this will only confuse users of our financial statements who understand how banks measure and manage credit risk. Moreover, defining such a broad term as financial risk so narrowly within U.S. GAAP may have unintended consequences in the future as the scope of financial instrument standards (including credit impairment) are being developed.

Some Financial Guarantees Result in the Recognition of a Financial Asset, Not Solely a Loss

In addition, the Proposed ASU fails to recognize that the funding of certain types of financial guarantees, upon the triggering of "an insured event", results in the recognition of a financial asset (i.e., a loan receivable), not solely the recognition of a loss, as with insurance. In this regard, these instruments are more akin to a loan commitment than insurance.

For example, our financial stand-by LOCs typically back financial claims such as commercial paper, tax-exempt securities, commercial or individual loans, lease agreements or other standby or commercial LOCs. Upon issuance, we stand obligated to the beneficiary (i.e., our client) to (1) repay money borrowed by or advanced to, the account of the account party (applicant) or (2) make payment on account of any indebtedness undertaken by the account party in the event the account party fails to fulfill its obligation to the beneficiary. However, if either event occurs, a cash payment is made to the

¹ Insurance risk is defined under the proposed ASU as risk arising from uncertainties about underwriting risk as opposed to financial risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

² Financial risk is defined under the proposed ASU as the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable.

beneficiary and a loan receivable is recognized on the balance sheet due from the account party. Operationally, PNC's standby LOCs are subject to the same underwriting and approval process as a loan.

Assuming a standby LOC with a term of one-year is measured under the proposed premium allocation approach (PAA), in the event the applicant defaults and we must perform under the LOC, the proposed guidance would require us to recognize a "liability for incurred claims...and a corresponding expense in net income."³ In its basis for conclusions, the Board concludes that this present value of expected cash flows approach, when a specified event is incurred, is an improvement to existing U.S. GAAP, which currently requires an undiscounted best estimate liability (or updating an initial estimate)⁴. However, this rationale fails to acknowledge that, with certain types of financial guarantee contracts, the issuer is not recognizing a liability as a result of the draw; rather it is recognizing a financial asset.

Moreover, it is unclear whether these kinds of products, once scoped into the Proposed ASU, would ever be subject to current loss contingency accounting⁵ to ensure that probable losses associated with the receivable are appropriately recognized. To us, it would seem more appropriate to consider these types of unfunded arrangements under the FASB's proposal on credit impairment.

This same accounting issue arises not only with standby LOCs but also with auction rate securities guarantees and liquidity facilities.

Scope Framework Lacks Clarity

The Proposed ASU also lacks clarity with respect to certain scope exceptions. For example, the Proposed ASU explicitly excludes guarantees of a reporting entity's own *future* performance from its scope⁶. However, it is unclear whether this scope exception, for example, applies to an entity's representations and warranties related to loans it originated in the *past*. The FASB's recent webcast on the scope of the Proposed ASU⁷ suggests that these are outside of the scope because they relate to the entity's *own* performance. While we agree with this interpretation, it appears to contradict the language in the proposed ASU related to future performance.

As such, we are unable to determine whether representations and warranties related to our own *past* performance are in or out of the scope of the Proposed ASU. This type of contingency represents a significant reserve on our balance sheet and a proposed change would require the implementation of an entirely new measurement model, which must incorporate a net cash flow approach, as opposed to the current loss (cash outflow) contingency approach under Topic 450-20 *Loss Contingencies*, and separately account for an implicit margin in the contractual arrangement.

In addition, assuming credit risk is characterized as insurance risk, it is unclear why financial guarantees whose payout may be linked to a downgrade in the credit rating of the borrower as opposed to an actual default would be scoped out of the Proposed ASU as financial risk, while the latter remains in scope. Although we don't agree with this position, if credit risk is considered insurance risk, then any

³ Proposed Accounting Standards Update, *Insurance Contracts (Topic 834)*, paragraph 834-10-35-32.

⁴ Proposed Accounting Standards Update, *Insurance Contracts (Topic 834)*, Basis for Conclusions, paragraph BC57.

⁵ FASB Topic ASC 450-20 *Loss Contingencies*

⁶ Proposed Accounting Standards Update, *Insurance Contracts (Topic 834)*, paragraph 834-10-15-5(k)(2).

⁷ FASB Webcast entitled *Insurance Contracts (Topic 834) – It's Not Just for Insurance Companies!* (presented on July 30, 2013).

underlying linked to it (e.g. a credit rating or credit index) should presumably be scoped in, provided the counterparty is exposed to risk throughout the guarantee's term.

Indemnities Do Not Fit Within the Proposed Measurement Models

The Proposed ASU also appears to scope in any kind of indemnity provision within any legal contract and requires that it be measured as insurance regardless of the level of uncertainty related to such cash outflows or the differences in provisions from contract to contract⁸.

PNC's indemnities arise from any number of contractual arrangements comprising a variety of different risks. For example, we provide indemnities to third-parties relating to the purchase and sale of entire businesses, loan portfolios, branch banks and partial interests in companies. When PNC is the seller, the indemnification provisions will generally provide the buyer with protection relating to the quality of the assets we are selling and the extent of any liabilities being assumed by the buyer. We also provide indemnifications in connection with securities offerings transactions, indemnifying underwriters or placement agents. As an underwriter or placement agent, we also provide limited indemnification to the issuer related to our actions in connection with the offering.

Due to the nature of these provisions and that most indemnities are resolved only after a case-specific collection process that often results in litigation, attempting to apply a standardized, probability-weighted approach across such varied provisions and any number of legal outcomes, however remote, would fail to produce a meaningful measurement for users of our financial statements.

Moreover, these proposed measurement approaches assume that we are being compensated solely for having taken on such risk, similar to a typical insurance contract. Attempting to extract an implicit "fee" from these provisions is a flaw in the scoping framework of the Proposed ASU and would require us to make overreaching assumptions in order to comply with the guidance. We do not believe it would provide meaningful information for our users.

Determining Whether to Apply the PAA or BBA to Financial Guarantees

Assuming financial guarantees are required to be scoped into the Proposed ASU, we believe it will be very difficult and time-consuming to determine which instruments must be measured under the premium allocation approach (PAA) versus the building block approach (BBA) based on the criteria in the Proposed ASU. Furthermore, we expect very little benefit for the effort required.

For example, our standby LOCs have terms ranging from less than one year to 6 years. For most of these contracts, the expectation of a draw on the LOC ranges from remote to less than 'more likely than not'. However, we believe that an assertion that it is unlikely that during the period before a claim is incurred that there will be significant variability in the expected value of the net cash flows required to fulfill the contract will probably require quantitative support, particularly for contracts whose term extends

⁸ We acknowledge that the Proposed ASU would exclude guarantees that are "both unusual and nonrecurring and unrelated to the type of risk that is the subject of other guarantees issued by the entity"; however, we believe that the application of this exception will be very subjective and, as a result, will likely result in more indemnities being scoped in to the Proposed ASU than scoped out.

beyond 1 ½ years⁹. Such a requirement brings to mind a similar quantitative-based risk versus reward analysis under the former FIN 46(R) used to determine which enterprise had a controlling interest (i.e., the primary beneficiary) in a variable interest entity. The Board subsequently replaced the quantitative analysis with a more effective and much less onerous qualitative approach in determining the primary beneficiary¹⁰.

Regardless, the measurement between PAA and the current FIN 45 model *prior to funding the LOC* is very similar. Assuming, after extensive quantitative work, that we determine that all of our LOCs should be measured under the PAA model, there is essentially no incremental benefit to applying the PAA model over the current FIN 45 model. And if a draw actually occurs, as mentioned before, the PAA model still fails to account for the recognition of a financial asset.

Remove Financial Guarantees from the Scope

For the above reasons, we recommend explicitly scoping out all financial guarantees and indemnification contracts which are addressed under existing U.S. GAAP standards or, similar to the IASB's proposed ED for insurance contracts, providing a policy election for these types of instruments.

Maintain the Fair Value Option

If the Board chooses not to scope out or to provide an election to scope out financial guarantees and other indemnification products, we suggest that the Board at least continue to allow reporting entities to elect the fair value option for these instruments to the extent they are eligible under Topic 825-10-15 *Fair Value Option*.

Focus on the Long-Duration Contract Model

We believe that a comprehensive reconsideration of U.S. GAAP insurance accounting is not necessary, particularly when we consider the significant cost of compliance for property/casualty and other short-duration contract businesses versus the benefit to users of their financial statements.

We suggest that the Board consider a targeted approach to improving the accounting for insurance contracts by focusing its efforts on improving the accounting for long-duration contracts, where the accounting disparities exist, rather than pursuing an overhaul of insurance contract accounting which overreaches in its scope and may cause more confusion for users of financial statements than it resolves.

⁹ We expect that anything at or near a one-year contractual term would likely fall within the PAA; however, as the contractual term lengthens several months beyond one year, we believe that only quantitative evidence will suffice as support for the PAA.

¹⁰ FASB ASC Topic 810-10 *Consolidation* (formerly Statement of Financial Accounting Standards No. 167 – Amendments to FASB Interpretation No. 46(R) – Summary)

We appreciate the Board's request for feedback on this matter and appreciate the opportunity to share our views with the Board and staff. We welcome any questions or comments you may have. Please contact me with any questions about PNC's comments at 412-762-7546.

Sincerely,



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