March 27, 2019

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Agenda Request – Accounting for Purchased Financial Assets That do not Meet the Definition of Purchased Financial Assets with Credit Deterioration

Dear Ms. Cosper:

TCF Financial Corporation ("TCF" or "we") appreciates the opportunity to submit an agenda request to the Financial Accounting Standards Board ("Board") to reevaluate the accounting for purchased financial assets that do not meet the Topic 326 Financial Instruments—Credit Losses ("Topic 326" or "standard") definition of purchased financial assets with credit deterioration ("PCD").

We believe that the standard, as written, does not result in the application of the same accounting model to non-PCD purchased assets, as compared to originated financial assets with similar characteristics, which is contrary to the Board's stated intent. The differences may result in non-PCD accounting that is confusing and lacks transparency to financial statement preparers and users. Further, for larger acquired portfolios we believe the standard as written could result in additional volatility for the purchased assets when compared to originated assets.

Issue

Subsequent to the standards effective date, financial assets acquired in a business combination and accounted for under the requirements of Subtopic 805-10 will need to be recorded at fair value on the acquisition date and record an allowance for credit loss. As a component of the fair value mark on the acquired financial assets is related to credit the standard results in effectively placing two credit marks or "double counting" on non-PCD acquired financial assets. One credit mark is embedded in the fair value of the asset and a second is recorded as part of the allowance for credit loss. This results in a net carrying amount of non-PCD acquired financial assets that is less than fair value and a net carrying amount that is lower than assets under the PCD model. We also believe that application of the non-PCD model, as currently written, is inconsistent with the intent of the standard and results in a measurement of non-PCD assets that would be different than originated loans.

> *326-20-30-1 The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. At the reporting date, an entity shall record an allowance for credit losses on financial assets within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).*

Application of the standard as written results in a net carrying value of non-PCD acquired assets that will be less than the net amount expected to be collected. We believe the results will be confusing to financial statement preparers and users, as non-PCD financial assets will reflect a double counting of expected credit losses on a post-acquisition basis, with the negative impact reflected in earnings in the period of the acquisition. In contrast, this double counting phenomenon will not occur with PCD financial assets. While the negative impact to earnings will gradually be "recaptured" through interest income accretion over the life of the acquired non-PCD financial assets, such an approach is counterintuitive and unnecessarily penalizes equity, to some degree, from the acquisition date through the reporting period in which expected losses are ultimately realized, when comparing acquired non-PCD to originated financial assets. This reduction to equity is particularly problematic, as this may result in a reduction to a bank's capital ratios. Under the guidance as written, the additional provision cost of a large acquired portfolio would negatively affect capital. This could have unintended consequences such as reduced lending capacity or impact the secondary market for certain types of loans because of the capital impacts to the purchaser. At a minimum, it will result in a bank that has grown through acquisition to have comparatively lower capital ratios than peers, all other things being equal. The accretion of the credit discount may also be problematic, as it will reflect a higher yield for purchased loans that we believe will not be intuitive to financial statement users. The income statement volatility created by the double counting of the credit mark will likely make it difficult for financial statement users to understand exact timing and nature of income recognition on purchased portfolios. These differences, which are driven by the accounting model and not the economics of the portfolio, could have negative impacts to a bank's credit rating or perceived value in capital markets, resulting in comparatively higher costs of capital.

While the PCD model will likely apply to a larger population of financial assets compared to the definition of purchased credit impaired ("PCI") under current guidance, our internal modeling would indicate that the majority of performing portfolios would not qualify as PCD in the current economic environment. As a result, the broader definition of PCD in comparison to PCI does not fully address this issue. The benefit of the expanded definition is largely dependent on the economic environment in place or expected in the period of acquisition. In addition, in a merger of similar sized banks with performing portfolios the majority of the acquired financial assets would be expected to fall into the non-PCD model. This results in significant measurement differences in the aggregate portfolios of the target company and the acquirer.

Background

Subtopic 326-20 requires the recognition of an allowance for credit losses, and related provision expense, in the period of acquisition for non-PCD assets. This contrasts with PCD financial assets where the allowance for credit loss is added to the purchase price (i.e., fair value) in determining the amortized cost basis pursuant to paragraph 326-20-30-13.

Subtopic 326-20 defines PCD as acquired individual or groups of financial assets with similar risk characteristics that, as of the acquisition date, have experienced a more-than-insignificant deterioration in credit quality since origination.

Paragraph 326-20-30-15 requires an entity to account for non-PCD financial assets in a manner consistent with originated financial assets. This includes paragraph 326-20-30-5, which among other requirements specifies that when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses when applying a non-discounted cash flow method.

We acknowledge the Board previously objected to the application of the gross-up method for financial assets purchased at or near par when there has not been a more-than-insignificant increase in credit risk because those assets should apply the same model as originated financial assets. The Board, in their basis for conclusion, stated that there was no inherent difference between financial assets acquired in a business combination and those acquired outside of a business combination. It is our belief that this does not take into consideration the impact of scale when measuring the allowance for credit loss. In the case of a merger of equals like the one we are in the process of, the application of the standard as written results in a potentially significant impact to the opening balance sheet of the combined entity as well as the earnings of the combined entity. (See Exhibit A for an example of how the double counting can significantly affect the financial statements of a merged entity.) While the Board's assertion that non-PCD financial assets purchased near par would not have more-than-insignificant increase in credit risk is true for individual assets, when applied to the equivalent of 50% of a merged banking entities portfolio the aggregate impact becomes significant. Given the current banking environment and move toward industry consolidation, the standard as written will result in significant comparability issues between those banks that have grown through acquisition(s) and those banks that have not, as comparability between acquisition driven growth and organic growth would become more difficult.

> *BC88. For purposes of measuring expected credit losses, the Board concluded that there is no inherent difference between assets acquired in a business combination and those that are purchased outside a business combination. The Board decided not to extend the gross-up approach to all purchased assets because (a) the credit risk may be difficult to reliably isolate from other discounts reflected in the purchase price when it is insignificant, (b) the benefits would not justify the incremental costs associated with a requirement to separate the credit and noncredit discounts when the amounts are insignificant, and (c) the accretion of the discount into income due to credit would be insignificant. The Board struggled with applying a gross-up method for financial assets purchased at or near par when there generally has not been a more-than-insignificant increase in credit risk because those assets should apply the same model as originated financial assets. The Board felt it had to draw a line and placed weight on user feedback stating that increased comparability is achieved by grossing up the allowance when there has been a more-than-insignificant increase in credit risk.*

The Board had three justifications for not applying the gross-up method more broadly, difficulty in application, cost benefit and insignificance of the financial statement impact. We believe that credit risk can be reliably isolated for acquired financial assets and the incremental cost of doing so is negligible. Fair value methodologies require consideration of credit and market impacts on valuations, further most models or pricing tools will separate the inputs or components. Since the information would generally be readily available, we do not believe that there would be significant incremental cost in determining the credit mark. The credit mark related to a non-PCD asset may be insignificant on an individual financial asset basis, but could be significant when evaluated in the aggregate. In the case of large mergers, the benefit more than outweighs the cost of separating the components as it results in a truer balance sheet presentation and less income statement volatility. In addition, the accretion of the credit discount can be significant when the scale of the acquired financial assets is large. (See Exhibit A for clarification.)

In light of these impacts, we urge the Board to consider (or reconsider) the approach for accounting for non-PCD purchased financial assets in a way that would better achieve the Board's objective of accounting equivalency between non-PCD purchased and originated financial assets.

Proposed Alternative Solution

We believe the most transparent and conceptually sound alternative would be to account for all acquired financial assets in a consistent manner. This means that the credit mark on non-PCD financial assets would be recognized as an addition to the purchase price of the asset in determining amortized cost. This approach would align the balance sheet accounting for both originated financial assets and acquired financial assets. The result would be a net carrying value of assets that would approximate the net amount expected to be collected, regardless of whether the financial asset was originated or acquired.

> *BC85. The Board concluded that purchased assets and originated assets should follow the same model, to the extent possible. At the same time, recognizing interest revenue on the basis of contractual cash flows for all purchased assets could result in situations in which an entity accretes to an amount that it does not expect to collect, which would result in artificially inflated yields. For this reason, the Board concluded that when recognizing interest income on certain assets, it is inappropriate to accrete from the purchase price to the contractual cash flows. Specifically, when a purchased asset has deteriorated more than insignificantly since origination, it is more decision useful to exclude the credit discount from the amount accreted to interest income. As a result, the discount embedded in the purchase price that is attributable to credit losses at the date of acquisition of a*

purchased financial asset with credit deterioration should not be recognized as interest income.

Further, by eliminating the double counting of the initial credit mark on acquired financial assets you eliminate the possibility of reflecting the acquired financial assets at a value that is below what is expected to be collected. While this alternative clearly makes sense in the case of a business combination, we would not object to the Board allowing an expedient for small portfolio acquisitions to be accounted for under the origination model. Such an expedient would address the Board's original concern related to the cost benefit of the accounting model on assets with an insignificant credit mark. It would ensure that the measurement of significant acquisitions would be reflected accurately on the balance sheet and that provision expense would be recognized for incremental credit losses not already priced into the value of the asset.

Conclusion

As described above, non-PCD accounting applied in the context of a business combination results in an initial post-acquisition carrying amount that is less than the net amount expected to be collected with an accompanying future gross-up of interest income by the amount of expected (and actual) credit losses. This also results in a significant initial impact to net income as the required increase in the allowance for credit loss is reflected in net income in the period of acquisition, despite the purchase price considering expected losses. We believe that having a consistent model for all acquired financial assets is the most transparent and conceptually sound alternative.

We appreciate the Board's consideration of the issue and would welcome the opportunity to discuss and provide further clarification on any of the matters discussed in this letter. Should you have further questions, please do not hesitate to contact me.

Sincerely,

Ted Clausen

Ted Clausen
Director of Financial Standards
TCF Financial Corporation
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Exhibit A – Illustrative Example

Assumptions

- Bank A acquires Bank B in a business combination
- Both banks have total assets of $10 billion with performing and high credit quality loan portfolios
- $9 billion of non-PCD loans acquired from Bank B, 5-year remaining life
- Contractual and market interest are 6%. No interest rate or other non-credit marks are required
- Constant default rate of 0.20%/year – applied at end of year
- Fair value of loans acquired is $8.966 billion
- Expected defaults total $38 million (CECL reserve)
- Estimated net income of the combined entity is approximately $200 million (based on FDIC Historical Bank Data using the 2017 ratio of income to total assets for the aggregate U.S. Commercial Banks)

Modeled Cash Flows (*in millions*)

Contractual Cash Flows

	BOP	Interest	Payment	EOP
Year 1	$ 9,000	$ 540	$ (2,137)	$ 7,403
Year 2	7,403	444	(2,137)	5,711
Year 3	5,711	343	(2,137)	3,917
Year 4	3,917	235	(2,137)	2,016
Year 5	2,016	121	(2,137)	0
		$ 1,683	$ (10,683)	

Expected Cash Flows

	BOP	Interest	Payment	Defaults	EOP	Accretion
Year 1	$ 9,000	$ 540	$ (2,136)	$ (15)	$ 7,389	$ 11
Year 2	7,389	443	(2,132)	(11)	5,689	9
Year 3	5,689	341	(2,128)	(8)	3,894	7
Year 4	3,894	234	(2,124)	(4)	2,000	5
Year 5	2,000	120	(2,120)		-	2
		$ 1,678	$ (10,640)	$ (38)		$ 34

Fair Value	$8,966
Discount	$34

Impact to Year 1 Reported Net Income

Provision Expense	$ (38)
Accretion	11
Tax effect	6
Net Impact	$ (21)
% of Total	-11%

Balance Sheet Impact

Carry Value of Acquired Loans	$ 8,928
Carry Value if Originated	$ 8,962

Note that the carrying amount less allowance for credit loss for non-PCD of $8.928 billion is below the net amount expected to be collected of $8.962 billion by $34 million on a post-acquisition basis, which is also the expected gross-up of interest income and credit losses over the contractual life of acquired non-PCD loans. In contrast, both originated and acquired PCD loans are carried, net of allowance for credit loss, at the net amount expected to be collected. The non-PCD accounting alternative recommended in this letter, would similarly equate the initial post-acquisition carrying amount, less allowance for credit loss, to be the same net amount expected to be collected as originated and PCD financial assets. We believe the assumptions used in this example are conservative in nature and impacts could be much more significant.