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# DUFF & PHELPS

Technical Director  
Financial Accounting Standards Board  
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May 31, 2013

International Accounting Standards  
Board 30 Cannon Street London EC4M  
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**Reference:** **FASB File Reference No. 2012-260**, Response to Proposed ASU:  
Financial Instruments – Credit Losses (Subtopic 825-15), and  
**IASB File Reference ED/2013/3**, Response to Exposure Draft on  
Financial Instruments: Expected Credit Losses

Dear Technical Director:

Duff & Phelps appreciates FASB's and IASB's efforts to develop a common high quality global standard for financial instruments that embodies meaningful accounting, and we appreciate the opportunity to be part of the comment letter process on the above referenced proposed ASU and Exposure Draft.

Our valuation advice, particularly with regards to financial reporting, is sought by hundreds of global clients annually as we work with them in developing pragmatic solutions for applying fair value techniques that are acceptable to the public accounting community.

We would be pleased to further discuss our comments with the Board and staff. Please direct any questions to either of us via the contact information set forth below.

Sincerely,



Jerry Arcy  
Managing Director  
Global Financial Services Leader



Jonathan Jacobs  
Managing Director  
Global Banking Leader



FASB/IASB

May 31, 2013

Response to FASB Proposed ASU:  
Financial Instruments – Credit Losses  
and IASB Exposure Draft on Financial  
Instruments: Expected Credit Losses

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## Observations

We are pleased to provide comment on the FASB and IASB financial instrument impairment documents, *Proposed ASU: Financial Instruments – Credit Losses (Subtopic 825-15)*, and *Exposure Draft Financial Instruments: Expected Credit Losses*, respectively.

Below are our key observations and areas of concern:

- **We are troubled by the lack of convergence between FASB and IASB on the credit impairment portion of their financial instruments projects**

One critical driving force behind the effort to revamp and converge the financial instruments standards has been the need to minimize systemic risk and ensure stability in the global financial system. This need has been reinforced by many stakeholders including the G20, the Basel Committee on Banking Supervision, the Financial Stability Board, and other interested parties. While the proposed expected credit loss models represent an improvement over the incurred loss models currently in existence, they fall short of a global standard that would promote the above goals.

- **The FASB and IASB address the issue from two different perspectives: conceptual and practical, respectively**

The FASB believes it is appropriate to recognize all expected credit losses at each reporting date, which we think generally reflects the correct *theoretical* and business management view of credit risk exposure (with the exception of double-counting initial credit loss estimates, discussed below). The FASB's approach is conceptually simple but practically challenging and costly to implement, especially for small financial services institutions and non-financial services companies. Even with large financial services companies, systems would need to be extensively modified.

One theoretical flaw in the model is that the discount rate applied to the expected credit losses (effective interest rate) already takes into account the credit risk priced in by the lender at origination and would have the effect of double-counting the initial estimate of credit losses. Reserving for assets upon origination questions the market pricing of transactions and the priority given to observable inputs represented by such transactions, as a matter of principle.

While this shortcoming may not have a significant net effect on an ongoing basis in open portfolios – where reserving for newly originated assets, existing assets and selling yet other portions of assets is a dynamic process that may balance out the effect of double-counting – the proposed approach does not properly reflect the economics on an individual asset level and for closed portfolios. The FASB approach may initially over-reserve for assets of lower quality which may (or may not) reverse upon disposition of the assets, resulting in losses and possibly gains. This infuses unnecessary volatility in the income statement and highlights the estimation challenges that arise for assets with long tenors. Thus, notwithstanding its conceptual appeal, the FASB model may be challenging to implement, as discussed in greater detail later in this letter.

The IASB, on the other hand, has taken a position against “excessive front-loading of losses” and has argued that the FASB’s approach does not account properly for the higher yield that a creditor demands of riskier loans. By using a dual-measurement model for credit reserves, we think that the IASB has adopted a view that has *practical* merit but is conceptually flawed in that it effectively uses a “recognition threshold “ in reserving for lifetime losses. Further, we find that the choice of 12 months for expected loss analysis purposes is inflexible. In some circumstances, particularly in consumer (or individual counterparty) loans accounted for on a pool level basis, information may be reliably forecasted for periods exceeding 12 months, and we believe (and recommend) that an expected credit loss model should allow for this.

The practical merits we see in the IASB approach are that it is less challenging to implement, may provide more reliable shorter-term estimates, and it may mitigate the potential impact, if any, on regulatory capital. Thus, the IASB model is more workable in the current business environment.

- **Even if conceptually appealing, life of loan estimates under the FASB approach may unduly increase earnings volatility**

Analysts and users tend to have more confidence in, and are generally more focused on shorter time frames when dealing with estimates, which are inherently subject to continuous change. Of those estimates, forecasting changes in credit is particularly challenging.

As evidenced by live transactions, perceptions about expected changes in credit quality can vary widely. Transacting parties have tried to bridge this gap by entering into loss sharing agreements; however, there are instances in which the parties could not even agree on the loss sharing arrangement itself. The result of requiring continuous credit change assessments over the life of the loan will be to infuse the process of credit loss estimation with this type of uncertainty and contention.

We believe that forecasting expected credit changes in the shorter term is more relevant and reliable, has a greater effect on the asset when considering the time value of money, and would reduce the undue volatility from applying an expected credit loss model that may arise from long estimation horizons.

Another alternative that FASB may consider would be to enhance fair value disclosures under ASC Topic 825 (formerly FAS 107), such that the assumptions related to probability of loss, loss given default and lifetime losses that underlie the fair value estimates are communicated to users in a meaningful level of disaggregation. This would provide users with insight on the assumptions underlying expected credit losses directionally, as well as would enable a comparison of the views of different institutions on the credit migration of their portfolios. The same disclosure would benefit IFRS users as well.

- **Reserves, and in particular, conservative reserves, pose earnings management risk**

A practical concern arising from a conservative approach and an extended time frame in reserving for credit losses is that it would provide an opportunity for earnings management. Robust implementation guidance and auditor and regulatory oversight would be critical in mitigating such risk.

- **Life of loan estimates may be difficult to make and audit**

Depending on the tenor and features of the instrument, some assumptions used in estimating expected lifetime credit losses

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may not be easily auditable. Ability to audit credit loss estimates is key, given the earnings management concerns expressed earlier.

- **Expected credit loss data availability and the comparability of resulting estimates could pose an industry-wide implementation issue**

We recommend that both Boards consider providing additional guidance to ensure consistency in understanding and interpretation by constituents, and make any expected credit loss estimates more robust and comparable among companies. Currently, there may be lack of adequate asset loss information at a given institution or shared within the industry to make this possible. For example:

- Smaller, younger institutions with higher credit quality portfolios may not have the requisite data to make their own credit loss estimates.
- For various reasons, records kept at institutions may not go far back enough to follow loss experience throughout the economic cycle or multiple economic cycles to fully capture the expected lifetime losses. Therefore, guidance as to the appropriate time horizons should be provided for various loan types.
- While the flexibility in choosing a method for estimating credit losses is a positive feature of the proposed models, this may inherently cause some loss of comparability due to use of different loss estimation techniques. For example, incurred loss statistics and probability of default could yield different estimates as the latter, in particular, may be subject to interpretation.
- There is no shared industry source of data that could be used to alleviate the above issues and promote comparability.

For reference, we are aware of the existence of one such source of shared data compiled by a regulatory authority via industry surveys, and such statistics were a primary source within the valuation of core deposit intangibles during the 1980s and 1990s. If a survey of this nature is pursued, it is important that specific statistics be accumulated by the underlying type, characteristics, geography of the financial instruments, as well as the participation be wide, in order to ensure confidentiality for the parties providing data.

- **We are concerned about the ramifications of the proposed credit loss models on regulatory capital**

We encourage FASB and IASB continue their dialogue with regulators to promote consistent interpretation of the proposed financial reporting models.

## Conclusion

We believe that convergence and/or compromise in the FASB and IASB proposed models are by far the most important goal in improving the guidance for financial instruments.

This critical objective is followed closely by the need for a continued dialogue with regulators on the suitability of the proposed changes in a prudential regulation context.

Further, a compromise should be explored as to the period of time over which expected credit losses should be captured, balancing a pragmatic approach with one that has conceptual merit.