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

April 1, 2011

Reference: FASB Reference No. 2011-150, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – Impairment*

Dear Ms. Cospers:

Duff & Phelps appreciates the opportunity to provide comments on the above referenced matter, especially as it relates to the ongoing convergence efforts of FASB and IASB in the area of financial instruments.

Our valuation advice, particularly in the context of financial reporting, is considered by hundreds of global clients annually, including 100+ clients in the financial services sector, as we work with them in developing pragmatic solutions for applying fair value and loss estimation techniques that are acceptable to the public accounting community. We believe that our unique perspective in the practical application of applying accounting principles -- both under United States generally accepted accounting principles and international financial reporting standards -- to financial instruments has particular relevance to the Boards and their constituency, as it relates to the supplementary document referenced above.

Specifically, we set forth an alternative proposal which we believe is directionally consistent with the Boards' previous deliberations and significantly simpler and more consistent with marketplace economics. The benefits we perceive inherent in this model include that it is:

- Doable. Operational as it can be implemented on a portfolio level.
- Simple. A calculation of the allowance for credit losses that can be applied across all assets of the portfolio, regardless of credit quality, without using a time-proportional allocation approach.
- Makes sense. An intuitive approach that can be applied to any portfolio, and not just limited to open portfolios.
- Auditable. Much of the data and assumptions needed for the model are already used for disclosure purposes under ASC Topic 825 (however, the proposed alternative does not require fair value).
- Self-correcting. It incorporates a mechanism which ties interest income and impairment into a net interest margin that reveals the true economics of the portfolio.

- Promotes comparability. It emphasizes net interest margin as a measure of performance to the users of financial statements.
- Consistent with business model. Many reporting entities use forms of this approach in trading portfolios, and in their budgeting and management compensation processes.

We would be pleased to further discuss our thinking with the Boards and staff. Please direct any questions to me via the contact information set forth below.

Sincerely,

A handwritten signature in blue ink, appearing to read "Jerry Arcy".

Jerry Arcy, CPA
Global Financial Service Leader

Attachment: Comments on the *Supplemental Document on Impairment*

Duff & Phelps Corporation (NYSE: DUF) is a leading independent valuation consultancy and financial advisory firm



FASB Reference No. 2011-150

April 1, 2011

Comments on the Supplemental Document:

Financial Instruments: Impairment

Financial Instruments (Topic 825) and
Derivatives and Hedging (Topic 815)

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Overview – *An Alternative Proposal*

As an advisor to many of the world's largest global and domestic companies that prepare financial statements under US generally accepted accounting principles or international financial reporting standards, Duff & Phelps¹ understands that there are differences of opinion as to how accounting standards should be modified, interpreted and applied. Moreover, we acknowledge the philosophical divide surrounding accounting for financial instruments.

In studying the Supplementary Document (SD), we find merit with the general direction of the arguments but remain concerned that the Boards' proposal incorrectly separates the interrelationship between impairment and interest income that exists in the business model at a pool level. We find that the language used in the SD infers, in part, that the Boards' view of impairment is still at an asset specific level. Moreover, we believe that the better objective would be to develop a *single accounting model* that (i) focuses on net realizable value of a pool of like assets and (ii) derives an allowance for the estimated difference between the contractual principal due from a counter-party and the net realizable value, also calculated on a pool level.

This Alternative Model is described below:

- The approach starts by aggregating the notional amount (amortized cost) of the assets comprising the portfolio, and projects the expected cash flows for the portfolio at the assessment date (assume 3/31/1X). The projections would incorporate defaults, loss severity and other expectations on a pool level and would in essence represent the net realizable cash flows from the portfolio, based on information (including future expectations) existing at that date. The rate that makes the projections equal to the amortized cost (IRR²) is the effective yield for the portfolio ("Rate 1") – it reflects the income that is expected to be generated, net of any estimated impairment losses over the term of the financial instrument.

¹ As one of the world's largest independent technical valuation advisors, Duff & Phelps provides a unique perspective in addressing complex valuation issues. We have firsthand knowledge of how accounting issues, with a valuation component, are addressed by a multitude of preparers, auditors, analysts, investors, and other technical valuation advisors. Our objective in working with preparers, auditors, regulators and standard setters is to render independent, objective advice to enhance best practices in financial reporting while ensuring pragmatism, relevance, consistency, quality, and compliance with fair value concepts.

² IRR – Internal Rate of Return

- This effective yield - Rate 1 - is used to accrue interest income for the next reporting period (the period from 3/31/1X to 6/30/1X, or “Period 1”), reflecting management’s best estimate of the underlying economics and net income generating capacity of the portfolio.
- At the next reporting date (6/30/1X), the cash flow projections are refreshed based on management’s expectations existing at this new date, and the net realizable value of the portfolio is computed using Rate 1. The absolute difference between the net realizable value and the amortized cost of the portfolio at 6/30/1X would represent the implied allowance for impairment. The difference in this new allowance amount, from the amount previously calculated at 3/31/1X would be charged/credited to interest income as a true-up to interest income earned in Period 1. In other words, this interest income/impairment recognition mechanism is self-adjusting.
- In summary, using the process above, a new net effective yield is calculated at each reporting date (6/30/X1 being the next one in this example), which is used to accrue income for the next period (this would be the period from 6/30/X1 to 9/30/1X, or “Period 2”), to be subsequently adjusted by a look-back at the next reporting date (9/30/1X in this example). Differences in effective yields period-to-period may arise due to additions or retirements (or other changes in the macro assumptions affecting managements estimate of future collectible cash flows) from the portfolio.

The benefits of our proposed Alternative Model are that it is:

- Doable. A model that is operational as it can be implemented on a portfolio level.
- Simple. A calculation of the allowance for credit losses that is straight-forward, does not require a time-proportional allocation and can be applied across all assets of the portfolio, regardless of credit quality.
- Makes sense. An intuitive approach that can be applied to any portfolio, and not just limited to open portfolios.
- Auditable. A model that is easily auditable. Much of the data and assumptions applied are already used for disclosure purposes under ASC Topic 825. Also, note that the net realizable value used to derive the allowance for credit losses is not fair value. The reconciling items between net realizable value and fair value presented in the disclosures include: 1) the effect of changes in the interest rate environment; and, 2) adjustments for illiquidity.

However, the data and analysis already used for disclosure purposes may be leveraged into our proposed alternative impairment model, on a portfolio level.

- Self-correcting. A self-correcting mechanism which ties interest income and impairment into a net interest margin that reveals the true economics of the portfolio by reflecting, on a timely basis, management's estimate of future events given the current environment.
- Promotes comparability. A means to promote comparability among preparers. Given the importance of net interest margin as a measure of performance to the users of the financial statements – both investors and management -- this focus would provide a significant benefit to the financial community and promote comparability among institutions.
- Consistent with business model. Many reporting entities use forms of this approach in trading portfolios, and in their budgeting and management compensation processes.

From our experience in performing purchase price allocations in the context of business combinations, we have found that the data necessary to implement the model above is available. Although an upfront effort may be required to summarize the contractual terms of the instruments, project cash flows, and apply macro-level analytics, our experience has been that (i) the current technology systems and (ii) accounting department / business unit personnel are capable of this task. Moreover, from discussions with our clients, we believe that the reporting entities' business decision makers are capable of assessing instrument quality and cash flow expectations on a pool level (many already do this as part of their interim planning and fair value analysis). The ongoing refresh effort in applying this model would be nominal.

Further, this approach allows for grouping all instruments in a single pool, rather than classifying them into a "good" book and "bad" book, or other categories. We find that the existence of separate subgroups complicates implementation both by virtue of having different approaches to calculating impairment for the different categories and because of the complexities associated with transferring instruments between categories. We believe that any relevant information about the composition of the portfolio may be captured through disclosure (e.g., the total currency amounts related to performing and non-performing instruments included in the portfolio).

* * * * *

Responses to Specific Questions General, Scope

While our comments³ include responses to the Boards' questions, we feel strongly that the Boards should further consider the concepts of the reporting entity's business model, the portfolio or pool level unit of account, as discussed above, in your quest for convergence in finalizing the Boards' guidance on financial instruments.

* * *

Following are our responses to the Boards' specific questions.

Question 1. *Do you believe the proposed approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, do you believe that proposed model should be revised and why?*

Duff & Phelps response. The proposed approach makes significant strides in the right direction. However, further improvements can be made to facilitate comparability and implementation. Please refer to our Alternative Model presented in the overview of this letter.

Also, while we support the concept of recognizing the present value of future expected credit losses through the life cycle of the pool of comparable financial instruments (both securities and loans), we believe that the concept should be applied to all instruments not just 'open' portfolios.

Question 2. *Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?*

Duff & Phelps response. We believe that it is important to have a *single impairment approach*, both for open and closed portfolios, as well as for assets of differing credit quality comprising such portfolios, as discussed in our Alternative Model. Carving out an approach that requires a different methodology, significantly more time to administer, affects only a small portion of a reporting entity's portfolio of instruments and has little impact on changing the 'economic value' of the net position adds little value. Further, multiple approaches tend to be more time consuming and less

³ Our commentary, as set forth herein, results from interaction of many of our managing directors and staff with a diverse and substantial client base. Over a rolling 24 month period, Duff & Phelps' client base typically consists of: one-half of the companies comprising the S&P 500, more than two-thirds of the 20 largest depository institutions in the US, more than two-thirds of the 50 largest private equity and hedge fund management firms in the world, and approximately one-half of the 10 largest public asset managers based in the US.

cost effective for the preparer and more confusing to the user of the financial statements (e.g., the current reporting for loan losses under SOP 03-3).

Rather, the goal should be to define a single system that effectively measures the present value of the expected future cash flows of the population and thus the effective yield to be realized.

Credit Loss

Question 3. *Do you agree that for financial assets in the 'good book' it is appropriate to recognize the impairment allowance using the proposed approach described above? Why or Why not?*

Duff & Phelps response. Again, while we support the concept of recognizing the present value of future expected credit losses through the life cycle of the pool of comparable financial instruments, we believe that the aggregate amount of impairment should be based on a pool level unit of account such that the present value of expected losses, estimated over the life of the instruments, is discounted at the accreted effective yield (for that period) for that pool, as discussed in our Alternative Model.

Question 4. *Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?*

Duff & Phelps response. We believe that this approach may be more operational on a pool level. From our observations of financial instruments in the credit markets, there is uncertainty with when a counterparty will default, how long a period of time will occur until a recovery materializes and what the ultimate amount of loss severity will be. However, when like instruments are aggregated at a pool level (e.g., all auto loans, or all BBB rated securities), the expected incident rate of default (i.e, the prospective default curve, and average period to resolution, and the recovery amount) are much easier to estimate. While management's estimates are necessary to forecast future events, they can be very insightful when developed with a balance of historical guidelines (considering industry cycles) and an assessment of the facts and circumstances in the current environment for the subject pool of financial instruments. Thus, estimating losses over time is possible at a pool level unit of account.⁴

⁴ While it is sometimes difficult to obtain the appropriate information in a cost-effective manner, once obtained, the information should lend itself to easy updates by the preparer in the future. The issue would be one of providing adequate transparency about the underlying data used by the preparer such that the users of the financial statements can interpret the expected losses and understand the effective yield of the pools of financial instruments, and get a sense as to consistency and comparability across preparers.

As far as the time-proportional allocation aspect of the impairment allowance, we believe that a simpler approach is available, one that is both easier to implement and that recognizes a net interest margin which reveals the true economics of the portfolio by reflecting, on a timely basis, management's estimate of future events given the current environment.

While recognizing impairment through the life cycle of the pool of comparable financial instruments is conceptually correct (and far superior to recognizing the entire impairment allowance upfront), the time-proportional allocation as a means of accomplishing this goal falls somewhat short as it is a smoothing mechanism with a built-in linear assumption between the passage of time and impairment. Meanwhile, for some financial assets, the likelihood of default and loss severity decreases with seasoning, whereas the time-proportionate impairment allocation would paint the opposite picture.

Question 5. *Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?*

Duff & Phelps response. If applied on a pool level, then yes, our observations of the market place are that both management and investors in pools of instruments are always analyzing what the expected future cash flows (contractual less expected losses) will be and more importantly, when variances from the norm will arise with expected credit losses.⁵ Disclosures in the notes that clearly explain the forward default/loss severity curves, the average time period to resolution and the discount rates applied to each pool (and management's explanation as to why the discount rate varied from the effective interest margin during the period) would be very helpful.

Question 6. *Is the proposed requirement to differentiate between the two groups (i.e. good book and bad book) for the purpose of determining the impairment allowance clearly described? IF not, how could it be describe more clearly?*

Duff & Phelps response. The differentiation between good book and bad book is not clearly defined, although it appears to be stated as a principle (being based on the "entity's risk management"). The risk of using a principle is that it is subject to interpretation and may result in less

⁵ ASC Topic 825 requires the disclosure of these pools of financial instruments on a fair value basis, which should incorporate future expected losses. Consistency in approach and application between preparers will help the users of the financial statements in their comparative analysis of institutions.

comparability among financial institutions. If the Boards' desire is to differentiate, we would recommend that such distinction fall along the lines of better defined and well-understood categories, such as performing and non-performing assets⁶.

Again, we recognize that the need to differentiate is driven by having two proposed impairment models. As described in the overview of our letter, we believe that the Boards' objective of timely recognition of expected credit losses can be accomplished by applying a single model on an overall portfolio level.

Question 7. *Is the proposed requirement to differentiate between the two groups (i.e., good book and bad book) for the purposes of determining the impairment allowance operational and/or auditable? If not, how could it be more operational or auditable?*

Duff & Phelps response. We believe that having dual categories based on a fluid distinction of different levels of credit risk and two impairment models creates additional complexity. Also, please see our response to Question 6.

Question 8. *Do you agree with the proposed requirement to differentiate the two groups (i.e., good book and bad book) for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?*

Duff & Phelps response. Not necessarily. While we see a difference between performing and non-performing (or defaulted) instruments, a significant portion of the amount of previously estimated impairment is often associated with the credit deterioration of the defaulted instrument. This is addressed in the probability of default and loss given default estimates used in estimating expected losses. Accordingly, the overall impairment amount of a performing pool would need to be continuously evaluated and adjusted downward, to reflect the prior recognition of expected losses for instruments that are expected to default, when transfers to the defaulted pool are made. This creates unnecessary

⁶ The Boards might be better served to define financial instruments along the traditional (business model) lines of performing and non-performing (i.e., a consumer counter party is more than 90 past due, or for commercial instruments – has defaulted on a contractual term other than required payment of principal and interest, or has filed bankruptcy). A related complexity with any dual-category model is that the recognition of the amount of impairment of non-performing instruments may require adjustment if the percentage of, timing of, and/or losses expected from such instruments are more than the amounts estimated as expected losses in the impairment measurement of performing assets in the period prior to classification as a non-performing asset.

operational challenges, also given the fluid distinction between good book/bad book.

However, as long as the concept is to estimate future expected cash flows – both collectible and non-collectible – over the life of the instrument pool, and such cash flows are considered and updated at each measurement period, we believe only one approach is necessary.

Minimum Impairment Amount

Question 9. *The Boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under the proposed model. Specifically, on the following issues:*

- a) *Do you agree with the proposal to require a floor for the impairment allowance related to the good book. Why or why not?*
- b) *Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the good book only in circumstances in which there is evidence of any early loss pattern?*
- c) *If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than 12 months)? Why or why not? If you disagree, how would you prefer the minimum allowance be determined and why?*
- d) *For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?*
- e) *Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than 12 months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.*
- f) *If you agree that the foreseeable future is typically a period greater than 12 months, to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognized under the floor requirement (for example, no more than 3 years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.*

Duff & Phelps response. We do not support the concept of a minimum allowance amount. As discussed earlier, we believe the allowance should be based on a *single model* that determines the expected cash flows to be

collected⁷ and subtracts that amount from the carrying amount of the instrument pool, provided that the allowance is not less than zero⁸.

Also, for impairment estimation purposes, we believe that the forecast period should be the greater of (i) the contractual term of the instrument or (ii) the expected term if the original instrument is anticipated to be refunded / refinanced (both of which would be much longer than 12 months).

For example, a pool of time share installment notes may often have expected losses that appear high on first blush (exceeding 25% of the original principal amount), however, such losses are offset by higher interest rates than other instruments have with lower losses. The additional interest should be considered with estimating the allowance, as we believe the goal is to present meaningful estimate of the pool's net collectibility as compared to the aggregate face amount of the instruments comprising the pool.

We have found that ample data exists when required to prepare purchase price allocations for financial instruments acquired, both as to loans and securities. Additionally, such information is often incorporated by preparers in their preparation of quarterly disclosures required under ASC Topic 825. Therefore, information exists to perform the appropriate analysis but it may not be easy to obtain on a cost-effective manner, especially for the initial estimation. However, thereafter, it should be relatively straightforward to update on a timely basis. The question that needs to be addressed is how the analysis can be performed on a consistent basis so that comparability between preparers can be assured when the users analyze the underlying financial statements.

Question 10. *Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.*

Duff & Phelps response. There should be no floor with the exception that the allowance should not be negative (see footnote 8). Under the Boards' concept, the present value of expected losses over the remaining term would also always exceed aggregate losses looking out 12 months except

⁷ The net realizable value approach given the effective yield used to accrete income for that period.

⁸ Theoretically, this can occur in a liquidating pool of mortgage-backed securities with high quality collateral which has appreciated over time. It can also occur in a credit card portfolio in which the expected cash flows incorporate significant delinquency and other fees that are unrelated to the interest charged.

when the remaining term is approximately 12 months or less (which suggests that the portfolio is in a run-off mode). More importantly, the concept of requiring a floor amount, and ignoring any above-average interest rate (or fee component) that contractually is in-place to mitigate the economic effect of such future losses associated with credit deterioration, is not consistent with the underlying (i) purpose of financial reporting, (ii) economics of the asset pool and (iii) goal of a meaningful estimate of the collectibility of the carrying value.

Question 11. *The Boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:*

- a) *Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the proposed approach described in para B8(a)? Why or why not?*
- b) *Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?*

Duff & Phelps response. Given the language as written, then yes to both. However, our preference would be that the reporting entity always consider the present value of expected cash flows of a pool of instruments, discounted at the effective yield at the beginning of the period. Also, it would be helpful to present in the notes a sensitivity table of variance in the amount based on alternative discount rates that are either 100 or 200 basis points higher and lower depending on management's judgment.⁹ Refer to our Alternative Model discussed in the overview of this document.

Question 12. *Would you prefer the IASB's approach for open portfolios of financial assets measured at amortized cost to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the IASB's approach (ie to recognize expected credit losses over the life of the assets)? Why or why not?*

Duff & Phelps response. As stated earlier, we believe that the amount of impairment is the amount that is derived by taking the expected cash flows to be collected *over the entire term* of the entire pool of financial assets, discounting such cash flows, and subtracting such amount from the stated

⁹ Additional disclosure in the notes addressing valuation allowances for liquidity impairments, and differences in discount rates and market participant's required yields might be helpful in reconciling to fair value of the asset pool.

amortized principal amount of the pool. Please refer to our Alternative Model discussed in the overview of our letter. We believe that the IASB approach is conceptually closer to this view.

Question 13. *Would you prefer the FASB's approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the FASB's approach (ie to recognize currently credit losses expected to occur in the foreseeable future)? Why or why not?*

Duff & Phelps response. No, immediate recognition of credit losses, undiscounted, is not addressing the underlying economics at the pool level and is misleading, overly conservative and potentially distorts net interest margin – a meaningful indicator of performance.