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September 10, 2013

Mr. Russell Golden
Chair
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856
United States

Mr. Hans Hoogervorst
Chair
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Re: Comment Letter on Financial Instruments: Expected Credit Losses (Impairments)

Dear Mr. Golden and Mr. Hoogervorst,

CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council ("CDPC"),[2] appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB") Proposed Accounting Standards Update ("Proposed Update"), *Financial Instruments – Credit Losses (Subtopic 825-15)* and the International Accounting Standards Board's ("IASB") Exposure Draft ("ED"), *Financial Instruments: Expected Credit Losses*. The FASB Proposed Update and IASB ED are collectively referred to as the Proposals. The FASB and the IASB are collectively referred to as the Boards.

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

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1 With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 116,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 137 countries, of whom more than 108,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 138 member societies in 60 countries and territories.

2 The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

EXECUTIVE SUMMARY

CFA Institute is issuing a single letter responding to both proposals of the FASB and IASB because investors are required to understand both IFRS and U.S. GAAP when making asset allocation decision across jurisdictions and different standards reduce comparability of financial results.

In order to inform the positions in this letter and provide comprehensive investor views regarding the Boards' impairment proposals, CFA Institute educated investors through a series of audiocasts, performed direct outreach to investors, with knowledge and experience in analyzing and investing in financial institutions, and conducted a global member survey regarding key elements of the proposals. The results of the survey and respondent comments are included throughout the comment letter in support or discussion of our views on convergence, impairment, interest income and disclosures. Below is a summary of our views and the survey findings which support such views.

Convergence

As expected, respondents to our survey overwhelmingly support a converged solution to assist investors who have to make comparisons and investment decisions across borders. A converged solution does not necessarily equate to a compromised solution taking parts of the FASB and parts of the IASB model to develop a hybrid approach. Rather, we believe the model to be selected should be the most economically relevant and decision-useful model for investors.

Impairment

Historical Perspective

As note in the body of the letter, CFA has long articulated its support for recognition and measurement principles for financial assets based on fair values. With a fair value based measurement method there would be no need for the determination of credit impairment estimates, interest income recognition patterns and allowance accounts as required by the Boards proposals. We do not believe that the expected credit loss models proposed by the Boards are less subjective or less complex than the use of fair value and we question whether they would more faithfully represent the underlying economics of the financial instruments to which they apply. These methods appear to be "accounting constructs" rather than a measurement, or recognition, method reflecting the underlying economics of the transactions currently occurring in the marketplace. We highlight in our letter that all the same criticisms which exist with respect to fair value (e.g. reliability and pro-cyclical) exist in at least equal degree to both impairment models.

In the body of our letter we highlight our previously stated concerns with respect to the non-economic nature of the proposal to recognize all expected credit losses at inception and we highlight investors' concerns regarding the impact of regulatory considerations in the developments of accounting standards which are meant to serve investors not regulators.

Investor Preference on Impairment Models

Survey respondents preferred fair value as the most decision-useful measure in reflecting credit losses with expected losses garnering slightly less support. Investors desire both management's expectations of credit losses and fair value since they have an interest in how management's expectations diverge from fair value and want to reconcile the expected loss and fair value measurements.

Survey respondents indicate a slight preference for IASB model over the FASB model. There is a preference for the FASB approach in the Americas and a preference for the IASB approach in EMEA and APAC. Comments revealed that the FASB model was preferred by some because of its prudence while others indicated it recognized unrealistic and non-economic charges up-front. The major objection to the IASB model was the 12-month expected loss recognition criteria did not have an economic foundation.

Time Value of Money & Discount Rates

Survey respondents overwhelmingly agreed that the time value of money should be incorporated into the measurement of credit explicitly rather than implicitly. They also indicated that the effective rate was the most appropriate rate for discounting expected credit losses.

Interest Income

The recognition and measurement of interest income is inextricably linked to the consideration of the measurement of credit impairments. The cash outflow for an investment and the cash inflow for its repayment, or failure to repay, are equated through either adjustments in credit impairment measurements or differences in measurement of net interest income. Both models simply equate the cash inflows and outflows differently, but, in either case, the amount and timing of interest income is impacted by the differences in methods.

Our direct outreach revealed that there was not a solid understanding of the interest income recognition pattern under each of the approaches or an understanding of the comparative analytic differences in interest income effects. It is important to enhance this understanding before completing the project. Accordingly, we recommend the Boards better articulate, illustrate and educate their stakeholders on the consequences of their decision.

The survey results indicate a preference for the IASB interest income model with a nearly equal preference for the IASB and FASB models in the Americas, though the Americas region had a higher preference for the FASB model than other regions.

Disclosures

While we traditionally seek disclosures which are solely complementary to the recognition and measurement principles in the financial statements we believe disclosures associated with these impairment proposals need to be especially robust.

Given that the Boards have not been able to develop a simplified and converged impairment model, we believe disclosures need to provide investors with the ability to analyze the sufficiency of management's estimates over time because: 1) the recognition and measurement principles developed for expected credit losses are not likely to reflect the underlying economics of the financial instruments, and 2) such measurements are likely to be less reliable than the related fair value estimates.

In our survey we asked respondents to rate the importance of certain key proposed disclosures related to the impairment models. We also included several disclosures which we believed were essential but omitted from the Boards' proposals. The survey found that disclosures related to understanding the assumptions and techniques used in estimating the allowance for expected credit losses were rated highest with the rollforward of the allowance for expected credit losses by type of credit rated lowest, but still with majority support. There was strong support for two disclosures – the development of expected credit loss estimates and the cash flow characteristics of financial instruments – which investors believe are essential to the decision-usefulness of the impairment model but which are not proposed to be included by the Boards.

Concluding the Impairment Project

We recognize that the Boards have been challenged in drawing this phase of the financial instruments project to a conclusion because of efforts to consider the interests of multiple constituencies. Multiple attempts have demonstrated that no single-model will satisfy regulator, investor and preparer interests. Giving priority to the information needs of investors – consistent with the IASB's and FASB's mission – our proposed resolution to the impairment project is as follows:

1) Develop a converged solution by selecting one model for recognition and measurement and disclose the other.
3) Incorporate explicitly rather than implicitly the time value of money using the effective interest rate.
4) Require additional key disclosures on developments of loss estimates and cash flow characteristics.
5) Provide fair value on the face of financial statements.
6) Provide for a better understanding of the interest income approaches and their effects.

Investors are willing to bear the cost of implementing a new impairment model if it provides greater insight into the underlying risks, their relationship to the expected losses recognized and the development of expected losses over time.

The impairment models proposed will be expected loss in nature, but the disclosures proposed do not include a development of the expected loss model. Accordingly, the expected loss estimates provide no greater insight into the assumptions and judgments made, and their accuracy over time, than does the existing incurred loss model. As investors step back from the changes proposed by the financial instruments project collectively they may find little improvement from existing guidance.

APPROACH TO OUR RESPONSE

CFA Institute decided to issue a combined response to both the FASB and IASB proposals. We believe that this is more effective than responding to the separate proposals because investors are concerned with both the development of high-quality accounting principles and the comparability of financial results across jurisdictions. Investing has become more global so the need for greater comparability of financial results across the world has increased and investors are required to be bi-lingual in IFRS and U.S. GAAP.

Further, CFA Institute has elected to respond to several key themes rather than addressing individual questions because the matters still under debate encompass broader conceptual issues.

INVESTOR EDUCATION & OUTREACH

In order to provide the Boards with comprehensive investor views and preferences regarding the impairment proposals, CFA Institute obtained feedback using a multifaceted approach. Each source of feedback was meant to build, complement and inform our response.

Investor Education

CFA Institute sponsored three audiocasts designed to educate investors and our members about the impairment models proposed by the IASB and the FASB. The first two webcasts were conducted by the IASB and FASB wherein Board members and staff presented the main attributes of their specific models. A third audiocast was conducted by CFA Institute subsequent to the individual Board presentations and provided a comparison of the IASB and FASB models and an investor perspective on the models. These audiocasts were developed to educate our membership in advance of a CFA Institute sponsored survey on the models. The three audiocasts resulted in approximately 2,000 views – an indication of the wide interest in the topic.

Investor Outreach

CFA Institute also conducted individualized conversations with investors, with knowledge and experience with analyzing and investing in financial institutions regarding their views on each of the proposals. These discussions provided us with the opportunity to hear practical concerns about the proposals. The feedback also helped inform not only our views on the Boards' proposals, but the form and content of our member survey. The conversations were held with buy-side investors and sell-side analysts in various regions of the world (i.e., Americas, Europe and Asia) – to reflect the global nature of our membership.

Investor Survey

To gain even greater insight and input, CFA Institute conducted a member survey which was distributed to our investor and analyst members across the globe (i.e., Americas (AMER), Asia Pacific (APAC), and Europe, Middle East and Africa (EMEA). The members were surveyed regarding key elements of the proposals including recognition and measurement or impairment losses and interest income and related disclosures. We also surveyed their views regarding convergence. Given the complexity of the Boards' proposals – and in order to better educate the survey respondents – we included a variety of interactive charts which provided key background information. Respondents were able to access these charts while completing the survey in order to better understand the proposals.

OVERALL COMMENTS

<u>CONVERGENCE</u>

CFA Institute has consistently supported a single-set of global financial reporting standards. We appreciate that the Boards have been challenged to arrive at an impairment loss model since the 2008 financial crisis. The numerous joint and individual attempts to develop an impairment model have been met with a mix of support and objection by a variety of constituent groups including users, preparers and regulators. However, as the Boards deliberate the proposals further, we believe it is important to remember that providing investors with decision-useful information is central to the mission of the FASB and IASB.

Because of the importance of cross-border comparability, as noted above, ***we believe that the IASB and the FASB should reach a converged solution*** as it relates to expected credit losses. We believe that users of financial statements would benefit from a single credit impairment model, and related disclosures, that improve consistency and comparability. The difference in the approaches proposed by the FASB and the IASB are likely to produce substantially different credit impairment and interest income recognition patterns over the life of a financial instrument. As a result, users investing in both U.S. GAAP and IFRS reporting companies will be unable to understand whether differences in reported income statement and balance sheet data reflect differences in portfolio loss characteristics or simply the application of different accounting standards.

In our conversations with investors – and in the member survey – there was nearly unanimous support for a converged standard. As noted in the following chart, 92% of respondents agreed that the FASB and the IASB should arrive at a method of estimating credit losses and interest income that is the same under both U.S. GAAP and IFRS.

The following elaborative comments from survey participants highlight this desire for convergence:

- *Accounting methods should not sit as an obstacle to valuation accuracy or efficiency, rule-making authorities should make every effort to make the financial statements more comparable for investors.*

- *The continual integration of U.S. GAAP and IFRS is critical. This has been brought to the forefront in recent times due to the increasing level of global body action.*

- *Reporting standards vary from country to country but minimization of differences is important toward global reporting practice.*

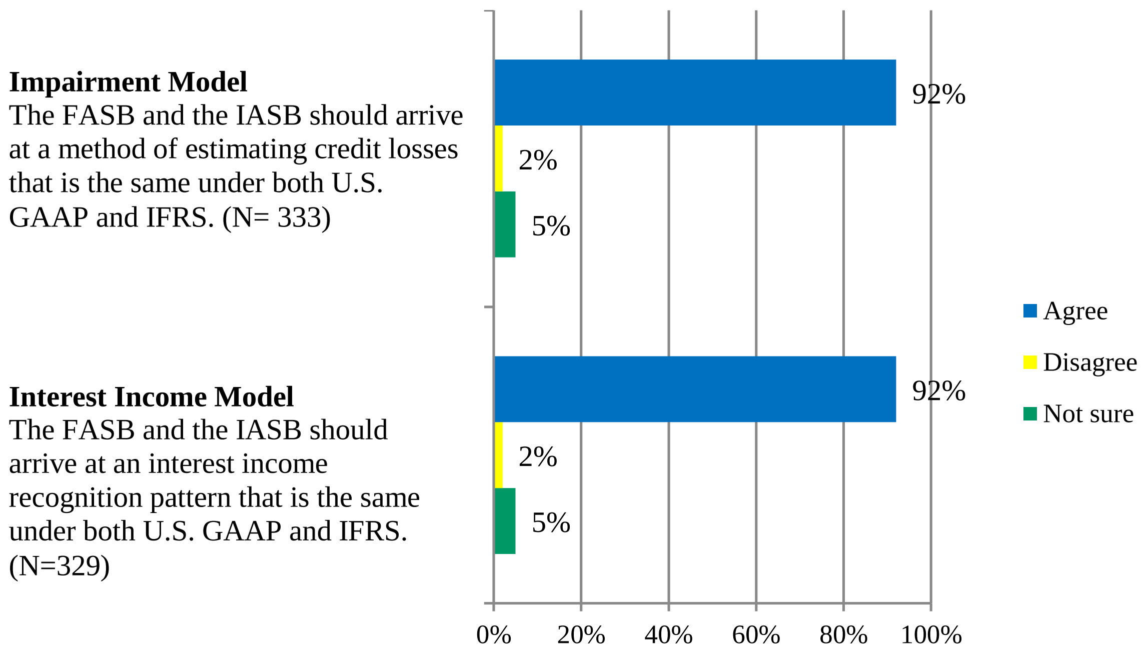
- *Having two sets of accounting standards is counterproductive – a dead weight loss.*

- *Obviously, otherwise it will become another point of divergence and complication.*

Despite the degree of difficulty in reaching convergence, we urge the Boards in their re-deliberations to strive for a single model for credit impairment and interest income.

CONVERGENCE

Please indicate whether you agree or disagree with the following statements:



Note: No significant variation in response by geographic region.

<u>CREDIT LOSS IMPAIRMENT MODEL</u>
Our Historical Position

<u>Our Historical Support for Fair Value as the Most Appropriate Measurement Basis</u>
CFA Institute has consistently articulated its support for recognition and measurement principles for financial assets based on fair values[3]. With a fair value based measurement method there would be no need for the determination of credit impairment estimates, interest income recognition patterns and allowance accounts required by the FASB and IASB proposals.

As stated in previous comment letters to the Boards, we do not believe that the proposed expected credit loss models are less subjective or less complex than the use of fair value and we question whether they would more faithfully represent the underlying economics of the underlying financial instruments. These methods appear to be "accounting constructs" rather than measurement, or recognition, methods that reflect the underlying economics of the transactions currently occurring in the marketplace.

<u>Our Historical View on the Recognition of Losses at Inception</u>
In our comment letter[4] to the 2010 FASB's initial financial instruments proposal to revise the accounting for financial instruments (Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities,* May 2010) (FASB 2010 FI Proposal) we made the following observation regarding impairment proposals which recognize credit losses at inception.

> For the reasons articulated below, ***we believe credit impairments should be based on an expected loss model considering an entity's historical loss experience and estimates of future changes to those expectations***. The objective does not articulate how the credit impairment should be measured, this is stated elsewhere, but implies that the recognition occurs when the expectation that all contract cash flows will not be received is satisfied.
>
> Inherently, however, ***when loans are priced there is an uncertainty premium charged based upon the notion that, on average, certain loans will experience a loss. This results in an expectation of losses at inception and the immediate recognition of such losses under the FASB approach. We do not agree with the proposal to the extent that it will result in the immediate recognition of impairment upon the origination of a loan, or purchase of securities***, based upon the notion that a historical loss ratio suggests, on average, a portfolio of loans, or securities, will produce a particular level of credit impairments.
>
> Such expectations are priced and reflect the risk uncertainty inherent in the extension of credit and are included in the interest rate charged on the instrument. ***<u>To recognize the loss immediately results in a reduction of income today and higher interest income in the future. Such an approach is not consistent with a fair value notion.</u>*** If a financial instrument is issued at a market interest rate (which includes an expectation of credit risk) a fair value based recognition model would not result in an immediate impairment because the risk charge would be reflected as interest income on the instrument. When the degree of credit risk uncertainty changes in the marketplace the fair value will adjust upward (downward) based upon the market's perception of the decrease (increase) in risk or the price of such credit risk.
>
> ***<u>Under an approach where impairments are taken immediately, the financial statement valuation will result in financial assets being reflected at a value below fair value – and if sold immediately thereafter result in the recognition of a gain upon disposal</u>***.

The FASB's current proposal requires even greater recognition of losses upfront than did the FASB's 2010 FI Proposal.

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3 Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. September 2010. Including CFA Institute Comment Letter http://www.cfainstitute.org/Comment%20Letters/20100930.pdf

4 Ibid.

Fundamental Support for Forward-Looking Expected Credit Loss Model
As noted from the excerpt above, CFA institute supports the use of an "expected loss" model in place of the current "incurred loss" model. We generally support an expected loss approach because it uses forward-looking information to estimate expected losses, which we believe is more consistent with the underlying pricing/valuation of such investments – and, therefore, closer to fair value and more economically relevant. An incurred loss model results in delayed recognition of credit losses, which we do not believe results in decision-useful information.

CFA Institute is supportive of the recognition of expected credit losses over the life of the financial asset as the uncertainty is resolved – because this is how the markets price and recognize such losses. We are concerned with an expected loss model which results in the immediate recognition of all expected credit losses at inception of a financial instrument (FASB Model) or with a model that recognizes expected credit losses related to the next 12 months (IASB Model). Our concern stems from the fact that neither model reflects the underlying economics of lending activities.

Because of our concerns with initial recognition of losses, we previously supported the IASB model (i.e. the IASB's first proposed model) whereby the original effective interest rate included a provision for expected credit losses and the allowance was established over time.

As we expand upon later, whether the IASB or FASB model is chosen, disclosures need to be an important element of the final proposal.

Criticisms of Fair Value Apply Equally to Proposed Impairment Approaches
In our comment letter to the FASB's 2010 FI Proposal we addressed all of the common criticisms of fair value. Principal among the criticisms of the fair value was its lack of reliability and the perception that it is pro-cyclical.

We observe that the same criticisms that are directed at fair value exist apply to both impairment models. These models include all of the same reliability issues as measurements made using fair value – given they are expected loss estimates – but they also have an additional reliability (representational faithfulness) issue that there is no requirement to use market inputs to the maximum extent possible. Similarly, if one believes that fair value is pro-cyclical[5], impairment models that are forward-looking in their assessment of expected losses would be equally pro-cyclical.

[5] We believe, and have stated often, that pro-cyclicality is an economic phenomenon that is independent of accounting principles.

Impairment Model: Regulator vs. Investor Considerations

Investor interests and regulatory interests are quite different. Prudential regulators have an informational advantage over credit and equity investors because they have the authority to mandate accounting and reporting requirements and they can, and do, force financial institutions to take actions they think are in the best interest of not only investors, but other stakeholders (e.g. depositors) as well as the safety and soundness of the financial system in a broader economic context. In addition, not all regulatory requirements are available to investors on a timely basis. Because of these considerations, CFA Institute's long-standing position has been that U.S. GAAP and IFRS should primarily serve the interests of investors and the Boards should focus on establishing financial reporting standards which provide investors with the most relevant decision-useful information.

Consistent with our historical position, we believe that when establishing new financial reporting requirements for expected credit losses the focus should be on meeting investor rather than regulator informational needs. During our outreach efforts many expressed concerns regarding the impact the changes to recognizing credit impairments will have on the regulatory reporting for banks – especially in the U.S. where the FASB's model recognizes all losses at inception and where prudential regulators utilize U.S. GAAP financial statements as a starting point for their regulatory filings. The principal concern is that the recognition of lifetime expected credit losses on day one in the case of the FASB model will increase bank capital requirements and result in real economic costs to investors. We heard that these investors prefer an expected credit loss model which will not impact regulatory capital requirements. Said differently, loss models for prudential regulatory and investor reporting should be different. That is not to say that credit losses for regulatory purposes are not of interest to these investors; they would simply prefer that regulatory reporting needs not be met through generally accepted accounting standards.

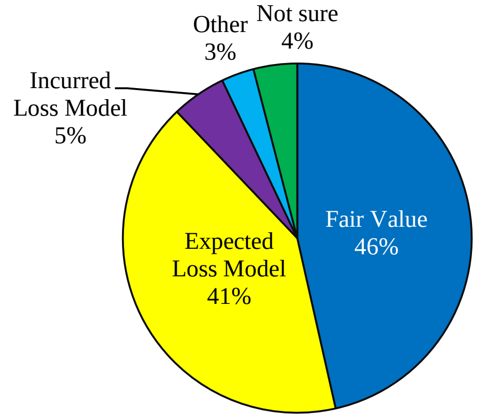
We believe that the Boards should adopt accounting standards that meet the needs of financial markets rather than those of regulators who have the power to mandate measurements that meet their needs.

Investor Views: The Most Decision-Useful Credit Impairment Model

Fair Value vs. Expected Loss Model vs. Incurred Loss Model

CFA Institute asked its members which approach was the most decision-useful in reflecting credit losses on financial instruments. The respondents showed a preference for fair value (46%) over the expected loss model (41%) with little support for retaining an incurred loss model (5%).

FAIR VALUE VS. EXPECTED LOSS MODEL



Select the approach that you believe is the most decision-useful in reflecting credit losses on financial instruments in financial statements. (N=355)

Note: No significant variation in response by geographic region.

The elaborative comments revealed that investors really wanted both pieces of information – management's expectations of credit losses and fair value. Investors have an interest in how management's expectations of expected losses diverge from fair value. A representative comment from one respondent is as follows:

- *Investors would need two critical pieces of information: management expectation of credit assets and fair value. Therefore, a combination of the fair value model with the expected credit loss model*.

- *I believe fair value is the ideal approximation for credit losses, it reflects the best estimate from the parties involved in the transaction. But without actual transaction data, financial institutions may need to rely on other statistics/methods to arrive at an estimate of credit losses. In this case, the expected loss method may better reflect credit quality change in a more timely manner than the incurred loss model. However, it also opens considerable room for manipulation, and the model may become too complex to understand and to challenge.*

- *Both current fair value (market value if possible) and expected loss should be disclosed. For full transparency the reasoning behind expected loss should also be disclosed.*

What we learned through our direct outreach is that investors want the ability to reconcile the expected loss and fair value measurements.

Other respondents noted their preference for fair value:

- *I see the benefits and drawbacks for both fair value as well as the expected loss model. Given that fair value is a little more transparent, and given the proclivity of banks to fudge the numbers wherever possible, I am going with fair value.*

- *Too subjective and too late for the incurred loss model. Too subjective with management's estimates for expected loss model. Fair value has both elements of subjective and objective which is much more defensible in terms of future litigation.*

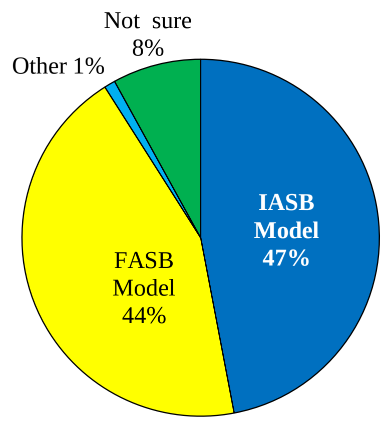
One respondent made an interesting observation regarding the expected versus incurred loss model:

- *Despite IFRS currently requiring the incurred loss model, my experience is that companies still used the expected loss model to estimate impairments and called this an incurred loss model.*

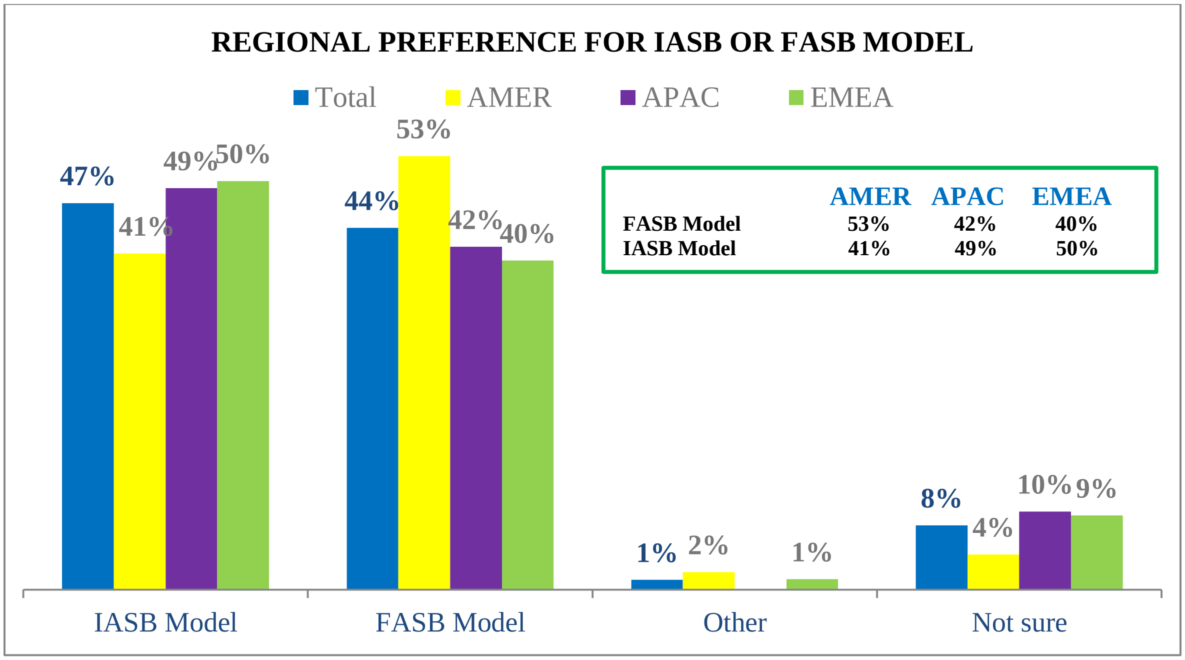
Expected Loss Model: Investor Preference for IASB Model or FASB Model

Our survey then asked investors which expected loss model, the IASB or the FASB model they preferred. The survey responses indicate a slight preference for the IASB Model (47%) over the FASB model (44%) as shown in the chart immediately below. We evaluated the results by region and found a preference for the FASB approach in the Americas and a preference for the IASB approach in EMEA and APAC.

PREFERENCE FOR IASB OR FASB MODEL



If an expected credit loss model is adopted, which model would you prefer? (N=332)



The following comments generally represent the competing preferences:

- *There is no need requiring initial 12-month expected loss recognition, after all, it holds no more merit than recognizing lifetime expected loss. There is little evidence saying credit quality will shift noticeably after one year or 12-months is a reflective point. In fact, it would be better for financial institutions to have a general expectation for credit losses, extending to the financial products' lifetime. When credit quality changes, they can adjust their estimation. After all, people who buy those credit assets are intending for the lifetime profit and loss rather than the initial 12 months.*

- *I see no reason to recognize "some" expected credit losses. What is the point of an arbitrary 12-month horizon? And the "significant deterioration" threshold will be played by management. I'm trying to forecast all losses that will come through the book, and that is what the FASB model provides for me.*

- *Even if it is an operational proxy of the initial matching of profit and loss, the model suggested by the IASB is a good compromise between the anticipation of loss compared to IAS 39 without having too high day 1 loss.*

  The 12-month expected loss framework helps smooth potential volatility in measuring credit risk which presumably will be made through credit default spreads.

- *The IASB proposal is needlessly complicated. It is confusing with its concepts of some loans having expected losses over one year and some over the lifetime.*

- *The FASB model makes sense as long as there are safeguards to prevent management from using any uncertainty in the estimation process to smooth their earnings.*

- *The FASB model is the most prudent and is therefore the most acceptable.*

- *The FASB model leads to unrealistically large swings in income.*

- *Penalizing loans at inception may reduce lending to the economy*

- *Long-term instruments would become quite problematic under the FASB model.*

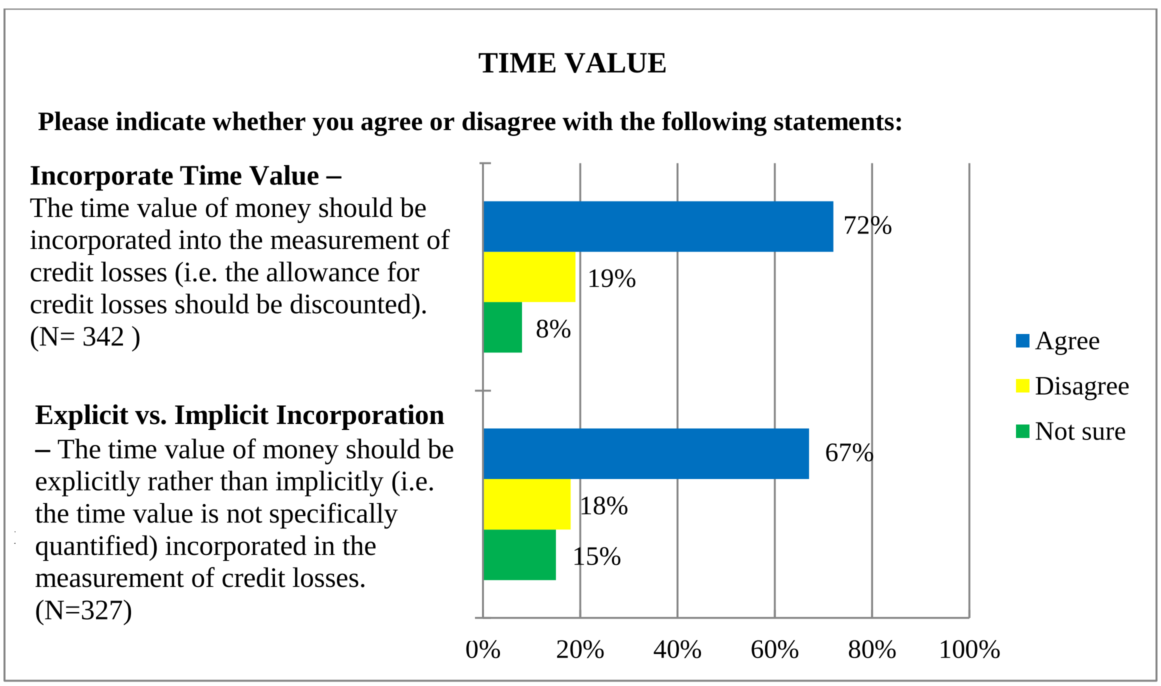
Overall review of the comments revealed that the FASB model was preferred by some because of its "prudence" while others felt it took unrealistic and non-economic charges up-front. The major objection to the IASB model was that it included the 12-month expected loss recognition criteria which respondents did not believe had an economic foundation.

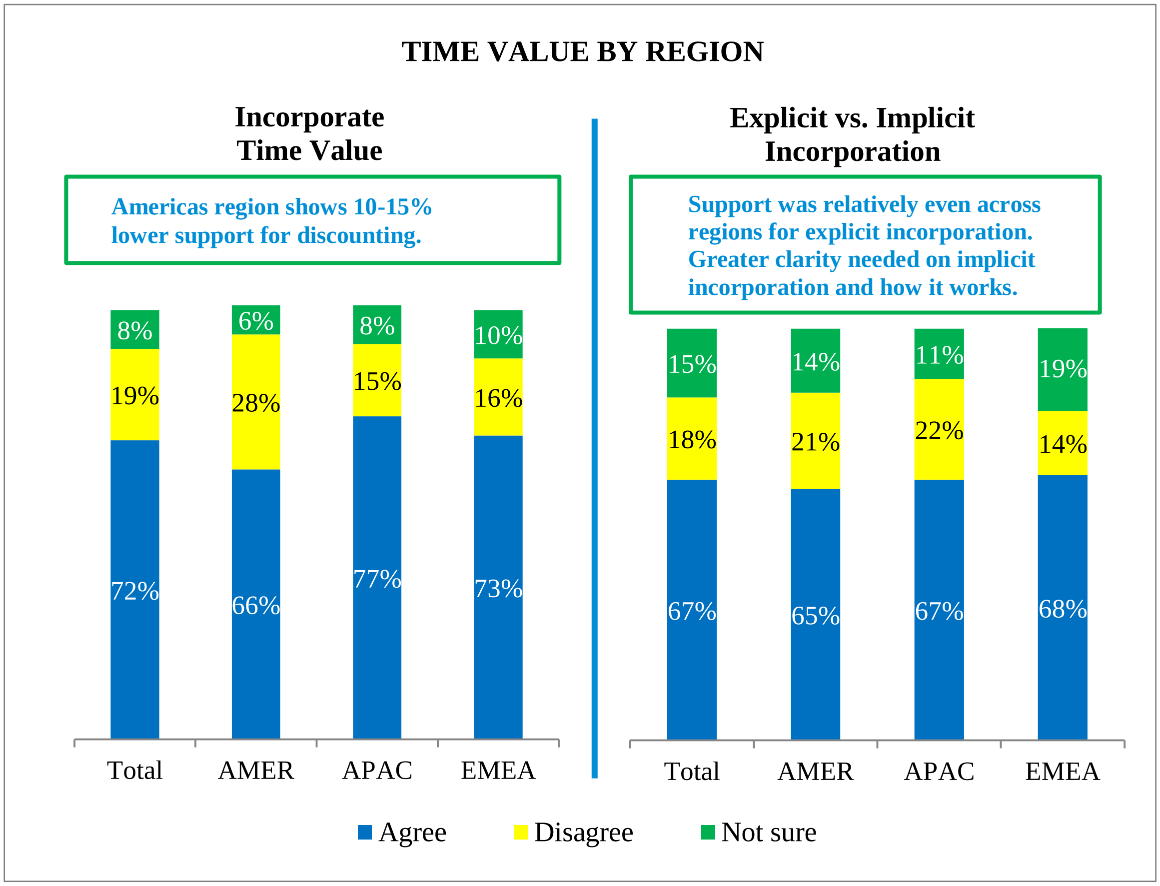
Time Value of Money: Perspectives on IASB vs. FASB Approaches and Discount Rate

The Boards have proposed different views on how the time value of money should be used in calculating expected credit losses. The FASB allows the time value of money to be recognized either explicitly or implicitly, whereas the IASB model calls for the time value of money to be recognized explicitly. Furthermore, there are differences in the discount rates to be used. The FASB proposal requires use of the original effective interest rate and the IASB allows a discount rate anywhere between the risk-free rate and the original effective interest rate. The use of different discount rates would be a further barrier to comparability between U.S. GAAP and IFRS companies and would introduce non-comparability even within IFRS reporting companies. We also believe that experience shows that preparer options never serve investors well.

Investor Perspectives on Incorporation of Discount Rate

Survey respondents overwhelmingly agreed – 72% of respondents – that the time value of money should be incorporated into the measurement of credit losses. The majority, 67% of respondents, felt that the time value of money should be explicitly rather than implicitly incorporated in the measurement of credit losses.



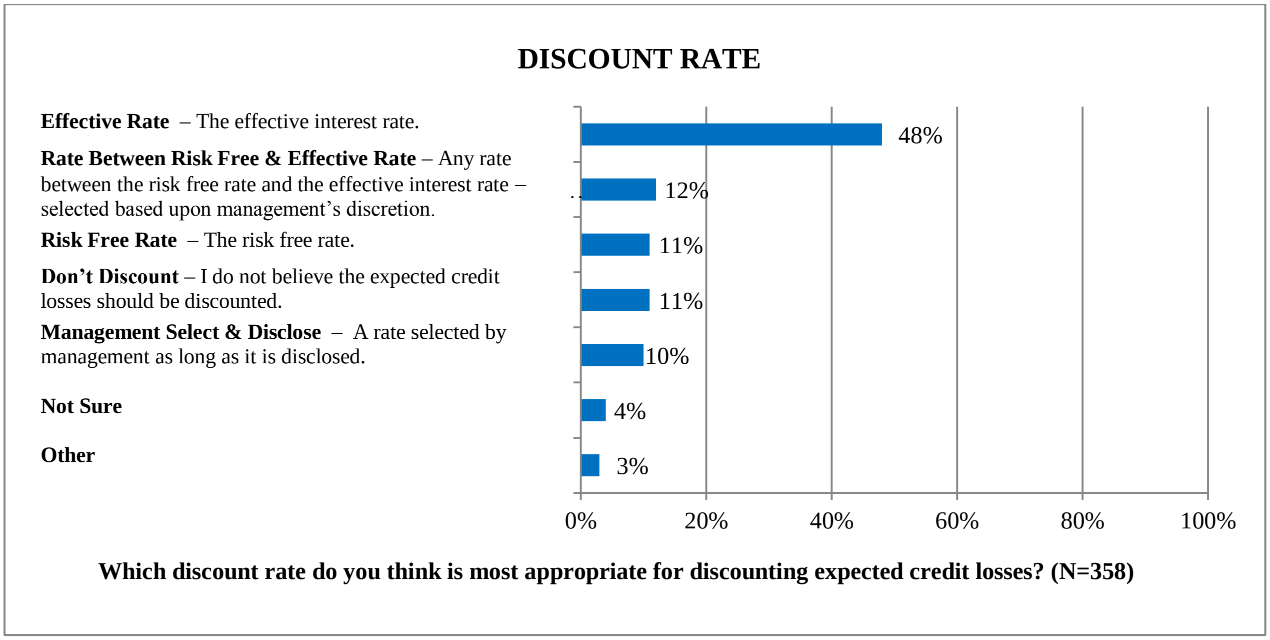


The respondent comments below are representative of why users prefer that the time value of money be explicitly incorporated and disclosed.

- *Need to separately disclose the time value of money, so as to aid decision making for investors.*
- *Valuation should reflect as closely as possible the realizable value of the investment if it were sold.*
- *Explicit time value of money would be better than implicit, but think that adding too much subjectivity isn't really positive. Disclosure on the detailed nature of the assets would be more helpful than anything. The market can make adjustments from that.*
- *The implicit mention of the time value of money in the FASB proposal could end up in entities performing different calculations between the US and Europe, whereas there is a need for convergence, at least on the expected loss measurement.*
- *Financial readers interpret impairments as some form of valuation, therefore the time value of money concept should be explicit.*

Investor Perspectives on Appropriate Discount Rate

In the survey, respondents were asked which rate is most appropriate for discounting expected credit losses (i.e., effective interest rate, risk free rate, any rate between the risk free rate and the effective interest rate at management's discretion or a rate selected by management as long as it is disclosed). Respondents noted a clear preference, 48%, for the effective interest rate.



The following comments offer investor perspectives on the interest rate:

- *Management would need to discuss the rationale for the selection of a discount rate and what components were evaluated.*
- *I don't especially like the EIR as the discount rate but it is better than the risk-free rate or leaving it up to management. The loans most likely to default are also likely to be those that had the highest EIR so this is also in the EIR's favor.*
- *The effective rate must be reasonable and not fudged by management.*
- *A rate that is closely related to the maturity of the instrument against which the credit loss impairment is being recorded.*
- *Effective interest rate for the appropriate time horizon, 6 months, one year, etc.*
- *I would like reasons given for the rate used.*
- *Market based rate appropriate as of the measurement date.*
- *I would like to think that the effective interest rate at the time of purchase would reflect the probability of loss.*
- *The risk free rate should not be used for discounting as it is unrealistic.*

INTERESTINCOME

The Inextricable Link Between Impairment Model and Interest Income

The appropriate recognition and measurement of interest income is inextricably linked to the consideration of the measurement of credit impairments. The cash outflow for an investment and the cash inflow for its repayment, or failure to repay, are equated through either adjustments in credit impairment measurements or differences in measurement of net interest income. The FASB and IASB models simply equate the cash inflows and outflows differently, but, in either case, interest income is impacted by the differences in methods. As such, we thought it was important to consider the nature of the interest income elements of each of the Boards proposals.

IASB vs. FASB Interest Income Methods:
More Outreach & Communication Needed to Enhance Investor Understanding

The principal focus of the education and outreach on the Board proposals has been on the recognition and measurement of the allowance for expected credit losses (i.e., lifetime or 12 months, etc.). Much less attention has been given to the method of recognizing interest income. The discussion on interest income is focused on the accounting mechanics rather than the pattern of interest income recognition and how it compares between the two models. Our direct outreach revealed that there wasn't a comprehensive understanding of the interest income recognition pattern under each of the Boards approaches or an understanding of the comparative differences in interest income approaches.

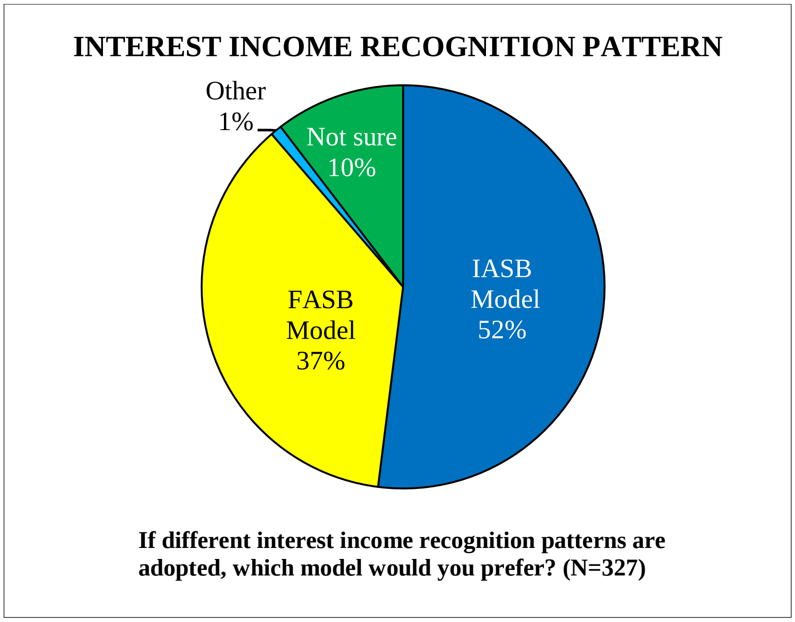
In our direct outreach we found investors were not aware of the fact that – assuming non-accrual under the FASB model and impairment under the IASB model occurred simultaneously – the FASB model would result in no net interest income and lower impairment losses where the IASB model would continue to recognize interest income and recognize a higher impairment. Again, this would assume that the timing of non-accrual and impairment recognition – the threshold for recognition of which is different under the FASB and IASB models happen at the same time. In our survey materials and background, we provided an articulation of the differences in approach to potential respondents to ensure they had an understanding of the approaches under consideration by both Boards.

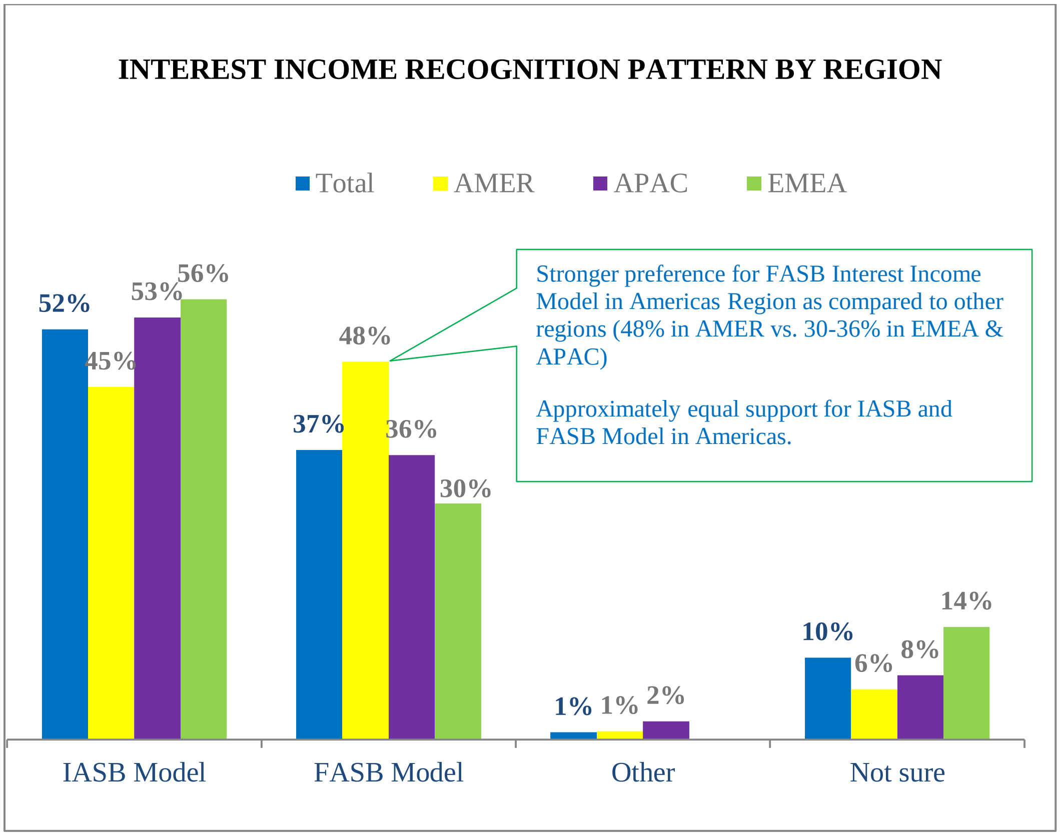
Given that the calculation of net interest margin is a key performance metric of importance to investors, it is essential that investors have an understanding of the interest income recognition approaches under both models and the implications of any changes from existing practices or differences between proposals. We believe that the Boards should engage in more extensive discussion of how interest income will be impacted by the credit loss model chosen. Based on our discussions with the Boards and outreach to investors we believe there could be greater outreach and communication on the issue of interest income recognition. We believe that a comprehensive illustration of the interest income effects on a comparative basis should be presented so that users will fully understand the impact of the difference in proposals.

As with the impairment model, investors prefer a converged interest income solution.

Investor Feedback on Interest Income Models

The survey asked respondents which model they preferred if different interest income recognition patterns were adopted. The results indicate that 52% prefer the IASB model with a nearly equal preference for the IASB and FASB model in the Americas, though the Americas region had a higher preference for the FASB model than other regions.





Representative respondent comments are as follows:

- *I like non-accrual guidance applied today by U.S. banks. It works and we understand it. No need to change that.*
- *When you write-down the loan you have taken the hit. Accrual of income is prudent after the write-down. Net income will appropriately reflect the write-down, net of interest income accrual.*

<u>DISCLOSURE</u>

Proposed IASB and FASB Disclosures

The Boards have developed disclosures designed to meet the information needs of the users of the financial statements. The objective is to further explain the amounts in the financial statements arising from expected credit losses and the effect of deterioration and improvements in credit risks. We believe that the disclosures proposed by the Boards will assist the users in their decision-making; however, as noted later in this section, we believe that two essential disclosures have been omitted from the proposals.

The following comment from one of the respondents is worth noting. It captures the essence of why robust disclosures are necessary.

> *Disclosure is the core concept to enable investors to determine whether the risk is bearable and/or consistent with their capabilities and appetites to bear the indigenous risks.*

Survey Results: Disclosures

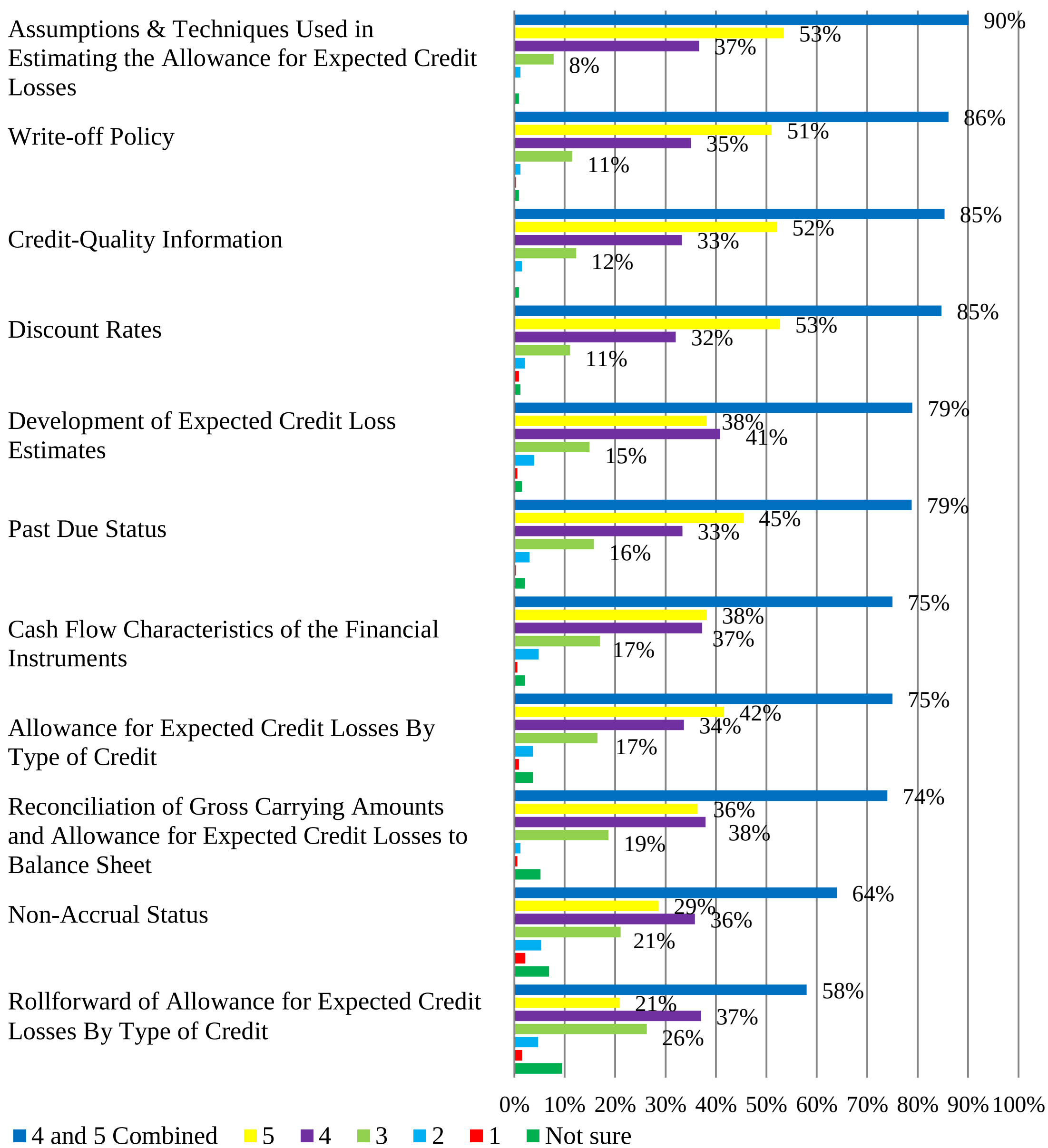
In the survey, CFA Institute asked respondents to rate the importance of certain disclosures related to the impairment models. As noted in the following table, many of the proposed disclosures were rated either "important" or "very important". The highest importance rating was 90% for the assumptions and techniques used in estimating the allowance for expected credit losses. The rollforward of the allowance for expected credit losses by type of credit was rated lowest at 58%. This is not to suggest that the rollforwards or reconciliations are unimportant. Rather, they reflect activity in the account while the assumptions used to develop the loss estimates and how they develop over time are more important to understanding the nature of the activity represented by the allowance rollforwards.

The following are representative comments on the topic of disclosures from the survey:

- *These disclosures should be sufficient for the investors to gain a reasonable understanding of the type of credit risks the organisation is exposed to and how well management has estimated these previously.*
- *All absolutely essential. Totally different pictures of the same entity may be easily drawn if either of these approaches is altered, therefore this information is essential for understanding the situation of the entity and for comparing its performance with peers across industry.*
- *If management wants to guesstimate valuations and therefore losses, they must disclose the model as well as all inputs.*
- *It's all good information!*

DISCLOSURES

Please rate the importance of the following disclosures related to impairments of financial assets (N = 334)



(5 = Very important →1 = Not at all important)

Two Essential, But Missing, Disclosures

The Boards proposals omit two disclosures which investors believe are essential to the decision-usefulness of the impairment model:

1) *Development of Expected Credit Loss Estimates* – The estimates of expected credit losses are highly subjective and dependent on management discretion. As noted above, the lack of reference to any market-based inputs increases investors' concerns related to the reliability of these impairment models. While rollforwards will provide information on the activity in the account, they will not provide investors with insight into the adequacy of management's judgments over time or how, when and why such estimates are changed.

   Accordingly, the Boards should require that entities provide a development of their expected loss estimates over time including a quantitative development table and qualitative description of changes in circumstances – much like insurers are required to provide on their loss reserve estimates.

   Without such disclosures, an expected loss model provides no greater insight into the assumptions and judgments made than does the existing incurred loss model. It is simply a set of estimates and investors are not able to evaluate these estimates over time – retaining the current state of transparency regarding impairment estimates. Further, some investors are concerned by preparer feedback that such developments cannot be provided as the information is not available as this suggests that managements lack the ability to understand, manage and assess the risks and profitability of the financial instruments they own.

   In the survey results above, 79% of respondents thought such a development of expected credit losses was "important" or "very important." This disclosure was considered secondary only to the disclosures regarding assumptions and techniques used in establishing the expected credit loss estimates and information regarding the underlying credit quality. One survey respondent put it best:

   > *In my opinion a development of expected credit losses estimates model is critical and the most important factor.*

2) *Cash Flow Characteristics of Financial Instruments* – As a part of the FASB's outreach on its 2010 FI Proposal, they found that users/investors preferred a mixed-measurement model with financial instruments such as loans at amortized cost. The FASB's outreach summary indicated investors' wanted disclosures, rather than measurement, of the fair value of financial instruments ***along with disclosures regarding the underlying cash flow characteristics of financial instruments***.[6]

   In 2012, the FASB issued an exposure draft on a proposed standard[7] which not only proposed disclosure of the expected cash flow characteristics of certain financial instruments and their related interest rate risk but also – through the use of tables – better illustrations of the liquidity, or liquidity gap, of the overall entity. This, like the original financial instruments proposal, was met with significant opposition by stakeholders other than investors indicating that such information was forward-looking and did not belong in the financial statements. Investors find this argument inconsistent with the fact that the measurements themselves are forward-looking. Disclosures which make the measurements meaningful to investors cannot be too forward-looking for inclusion in the financial statements when the measurements included within the financial statements are themselves forward-looking.

   Our direct outreach to members and investors told us that investors find the disclosure of the cash flow characteristics to be highly decision-useful information. What we heard during our 2010 outreach related to the FASB's 2010 FI Proposal was that those who favored a mixed measurement model did so with the condition that they also be provided with these cash flow characteristics. Their reasoning was that they wanted to model the valuation of the financial instruments themselves.

   The importance of such disclosures to investors is validated in the survey results presented above, where 75% of respondents thought disclosures of the cash flow characteristics of financial instruments were "important" or "very important." This disclosure scored higher than the allowance for expected losses by type of credit, reconciliation of the allowance to the balance sheet, the non-accrual status and the rollforward of the allowance for loan losses. One respondent said it best:

   > *Disclosure on the detailed nature of the assets would be more helpful than anything. The market can make adjustments from that.*

Overall, we find that investors believe two key additional disclosures are essential to improving the financial reporting for credit losses.

[6] This outreach was not consistent with CFA Institute members' views on the topic of the application of fair value to financial instruments. CFA Institute surveys showed that members preferred the use of fair value.

[7] Proposed Accounting Standards Update, *Disclosures About Liquidity Risk and Interest Rate Risk,* June 2012.

Disclosures: Not a Substitute for Recognition and Measurement, But Especially Important With Credit Impairment Estimates

One of CFA Institute's key financial reporting principles as articulated in our publication *A Comprehensive Business Reporting Model: Financial Reporting for Investors* is that disclosures must provide the additional information investors require to understand the items recognized in the financial statements, their measurement properties, and their risks. As further stated in this principle, ***disclosures are not a substitute for recognition and measurement*** in the financial statements. They are, however, and essential complement if investors are to understand the financial statements.

Given that the Boards have not been able to develop a simplified and converged impairment model, we believe disclosures need to play a more important role in the development of this standard for two reasons:

1) The recognition and measurement principles developed for expected credit losses in the financial statements are not likely to reflect the underlying economics of the financial instruments, and
2) such measurements are likely to be lower in reliability than the related fair value estimates.

While we traditionally seek disclosures which are solely complementary to the recognition and measurement principles in the financial statements, for the aforementioned reasons, we believe disclosures associated with these impairment proposals need to be especially robust and enable investors the ability to analyze the sufficiency of management's estimates over time. It is important that the disclosures include all of the key attributes described in the survey results and with particular emphasis on the inclusion of the development of expected credit losses and the cash flow characteristics of financial instruments.

What we have also learned in our outreach is that investors will seek to reconcile and understand the differences between financial instruments measured at amortized cost and reduced by impairment losses determined under an expected loss method and the fair value of such financial instruments. The survey results above which indicate that investors want both expected loss and fair value measurements is further evidence of this fact. Disclosures will be sought which facilitate enhancing the understanding of both measurements and how they relate to each other. If not provided, we would expect that analysts will likely ask questions regarding the relationship between the two measurements.

CONCLUDING THE IMPAIRMENT PROJECT

We recognize that the Boards have been challenged in drawing this phase of the financial instruments project to a conclusion because of efforts to consider the interests of multiple constituencies. Many believe the IASB model is more appropriate while others believe the FASB model is most appropriate. Multiple attempts have demonstrated that no single-model will satisfy regulator, investor and preparer interests. Any solution is going to result in a constituency which is displeased with the conclusion, and there will be costs of changing under either approach.

Giving priority to the information needs of investors – consist with the IASB's and FASB's missions – our proposed resolution to the impairment project is as follows:

1) *Develop A Converged Solution* – Arrive at a converged solution. The lack of a converged solution creates the greatest burden on analysts and investors especially who have to make comparisons across borders. A converged solution does not necessarily equate to a compromised solution taking parts of the FASB and parts of the IASB model to develop a hybrid approach. Rather, we believe the model selected should be the most economically relevant model which addresses the initial objectives of the project.
2) *Select One Model & Disclose The Other* – As we stated above, we do not believe recognizing all expected losses at inception is an economically relevant measurement. Accordingly, we find it challenging to support the FASB model. We disagree with the IASB's 12-month expected loss period as it lacks grounding in the underlying risk and economics of the financial instruments to which it is to relate. We prefer the IASB's original impairment model on the grounds that it best reflects the underlying economics of the financial instrument. For those who find the FASB model useful – or who prefer a "prudent" or prudential regulator view – we would recommend disclosure of the expected losses at inception (as calculated under the FASB model). In such a way regulators and other users preferring information about the total expected losses are satisfied.
3) *Time Value & Discount Rate: Incorporate Explicitly, Use Effective Rate & Disclose* – As the survey supports, we believe it is essential that time value be incorporated explicitly into the estimate of expected credit losses. There was strong preference for use of the effective rate – not a rate between the risk free rate and effective rate. Disclosure of the discount rate used was also rated "important" or "very important" by 85% of the respondents.
4) *Disclosures Are Essential Given Subjectivity & Reliability Issues Surrounding Estimates: Key Disclosures on Loss Developments & Cash Flow Characteristics Need to Be Added* – As we have articulated above, we believe it is especially important – given the subjectivity and reliability concerns associated with these expected loss estimates – to focus on disclosures as a part of completing the impairment project. Transparency regarding assumptions and techniques used in developing expected credit loss estimates, the expected development of credit losses and the cash flow characteristics of the financial instruments are essential to making any change in the impairment models substantively more meaningful than the incurred loss estimates currently utilized.

5) *Provide Fair Value on the Face of Financial Statements* – Because investors will be interested in the relationship between the amortized cost less impairment and fair value, we believe it is important for the FASB and IASB to require disclosure of the fair value of the financial instruments on the face of the financial statements to provide investors with all relevant information related to the financial instruments when earnings are released.
6) *Enhance Understanding of Interest Income Approaches* – As the survey indicates, 52% of respondents support the interest income approach under the IASB model where interest income continues to be recognized post impairment. As noted previously, we believe greater awareness is required of the differences between the IASB and FASB interest income recognition models. The focus of outreach to investors has been on the impairment model and the mechanics – rather than the analytical differences – in approach.

Investors are willing to bear the cost of implementing a new impairment model if it provides greater insight into the underlying risks, their relationship to the expected losses recognized and the development of the expected losses over time. Our concern, however, is that as investors step back from the current financial instrument project proposals (classification and measurement combined with impairment) and consider how they have improved transparency into the underlying risks and their relationship to the expected losses recognized, they may perceive little improvement. Classification and measurement will remain based upon a mixed measurement model – with the disclosure of fair value more contemporaneously disclosed under the FASB's approach than under the IASB's approach. The impairment models proposed will be expected loss in nature, but the disclosures proposed do not include details of the development of the expected losses over time. Accordingly, the expected loss estimates may provide little more insight into the assumptions and judgments made, and their accuracy over time, than does the existing incurred loss model.

Sophisticated investors – price makers – with the information provided through the disclosures we seek could make appropriate market estimates of the expected losses. Such information would be decision-useful and would satisfy investors and regulators. As one respondent noted:

> *Disclosure on the detailed nature of the assets would be more helpful than anything. The market can make adjustments from that.*

Investors are skeptical of the argument that modifications to the impairment model or disclosures should not be made because the underlying data or models do not presently exist or that models may be too costly or too challenging, but not impossible, to implement. It is the experience of investors that what gets measured and disclosed is what gets monitored (e.g. pension liabilities) and the financial crisis demonstrated a greater need for monitoring and transparency regarding impairment estimates. Investors are willing to incur the cost of such additional disclosures if they are provided meaningful transparency into the estimate of expected credit losses.

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Thank you again for the opportunity to comment on the Proposals. If you or your staff have questions or seek further elaboration of our views, please contact either Matthew Waldron, CPA, by phone at +1.212.705.1733, or by e-mail at matthew.waldron@cfainstitute.org or Sandra J. Peters, CPA, CFA by phone at +1.212.754.8350 or by email at sandra.peters@cfainstitute.org.

Sincerely,

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/s/ Ashwinpaul C. Sondhi

Ashwinpaul C. Sondhi
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council