CFA Institute

CREDIT LOSS AND IMPAIRMENT SURVEY

August 2013

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Executive Summary

The global financial crisis highlighted the need for more timely recognition of credit losses on loans and other financial instruments held by banks, lending institutions, and public and private organizations. Many believe the existing "incurred loss" model failed to alert investors to credit losses in a timely manner given such a model required a loss triggering event to recognize the losses.

To address this criticism, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively the Boards) have been exploring alternatives to this model that would use a more forward-looking "expected loss" approach for recognizing credit losses (i.e. impairments). After several attempts at individual and joint solutions, the Boards recently released independent proposals and sought comments (the Proposals).

CFA Institute conducted a global member survey in July 2013 regarding key elements of the Proposals in order to provide support for our views on impairment, including the related recognition and measurement of interest income and the supporting disclosures. We also sought member views on the need for a converged solution. Highlights from the member survey, the details of which follow, include:

- **Convergence** – Respondents overwhelmingly (92%) support the FASB and the IASB arriving at a method of estimating credit losses that is the same under both U.S. Generally Accepted Accounting Standards (U.S. GAAP) and International Financial Reporting Standards (IFRS). They have a similar opinion with respect to interest income recognition.
- **Impairment Model** –
  - When asked what method of measuring credit losses would be most decision-useful, 46% indicated fair value would be their preference over the expected credit loss model (41%). Interestingly, the comments reflect a desire by investors for both measurements because of a need to reconcile and understand the differences in measurement (i.e. fair value being utilized as a reference point for expected losses).
  - When asked whether they preferred the IASB or FASB's expected loss model, there was a slight preference for the IASB model (47%) over the FASB model (44%). There were, however, distinct regional preferences.
- **Interest Income Recognition** – As to the interest income recognition pattern, a majority favored the IASB model (52%), whereas 37% favored the FASB model. Our member survey and direct outreach indicates the Boards need greater communication outreach and comparison of interest income recognition approaches.
- **Disclosures** – Disclosures related to underlying assumptions and credit-quality were rated highest by respondents (e.g. assumptions & techniques, credit-quality information, write-off policy and discount rate). Missing, but extremely important to investors, were disclosures related to:
  - the development of expected credit loss estimates (79%) and
  - the cash flow characteristics of financial instruments (75%).

Respondents to the survey were invited to provide elaborative comments to each question and regarding other matters they deemed important. These comments were especially helpful in providing insight and context to the reasoning behind member responses. Selected representative comments are included throughout the survey report.

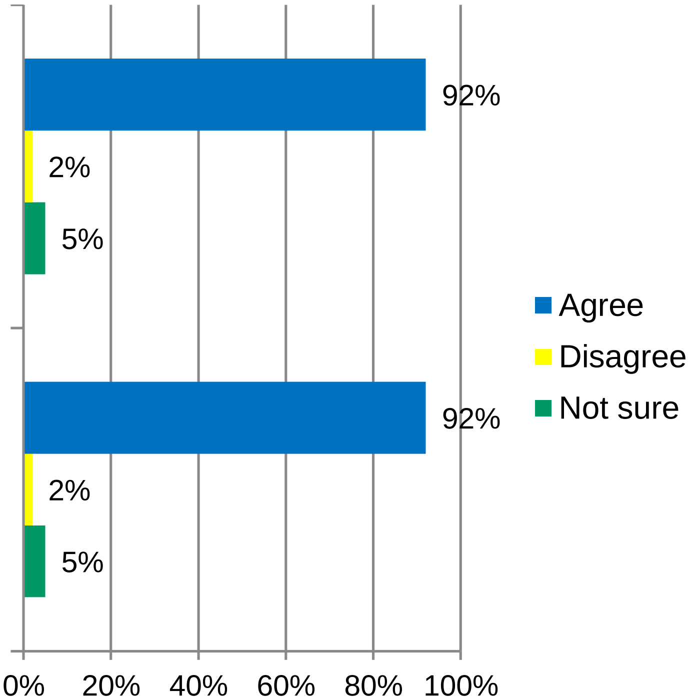
+These survey results, as well as our direct member outreach, were an integral component of our comment letter, *Financial Instruments: Expected Credit Losses (Impairments)* to the Boards on their Proposals.

Convergence

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

Impairment Model
The FASB and the IASB should arrive at a method of estimating credit losses that is the same under both U.S. GAAP and IFRS. (N= 333)

Interest Income Model
The FASB and the IASB should arrive at an interest income recognition pattern that is the same under both U.S. GAAP and IFRS. (N=329)



Observations

- **Support for Converged Solution:** Investors overwhelmingly support the FASB and the IASB arriving at a converged solution for both estimating credit losses (92%) and recognizing interest income (92%).

- **Basis of Investor Support for a Converged Solution:** Investors make investment decisions by comparing investments in companies located in countries with different accounting, auditing, tax, regulatory and other business practices, cultures, and languages.

  As markets become increasingly global, it is vitally important that investors be able to rely on financial reporting by companies in different jurisdictions to make relevant comparisons.

  The large number of countries adopting IFRS and the number of investors owning securities of companies around the world highlights the importance to investors of a single financial "language." This common financial reporting language improves transparency and enables investors to make comparisons between similar entities across jurisdictions.

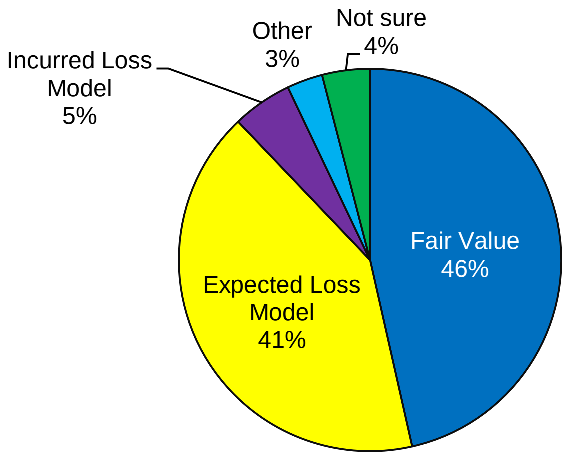
Convergence

Respondent Comments

- *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.*

Most Decision Useful Model for Measuring Credit Losses

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



Observations

- **Preference for Fair Value:** Respondents indicated a slight preference (46%) for fair value over the expected credit loss model (41%). This preference is consistent with CFA Institute's position that fair value measurement for financial instruments provides the most decision-useful information.

- **Combination of Fair Value and Expected Credit Losses:** Through respondent comments we learned that investors want disclosure of both the expected credit losses and fair value as they believed a combination of the two provides the most meaningful information. It also reflects a desire to reconcile the two values/approaches.

Respondent Comments

- *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.*

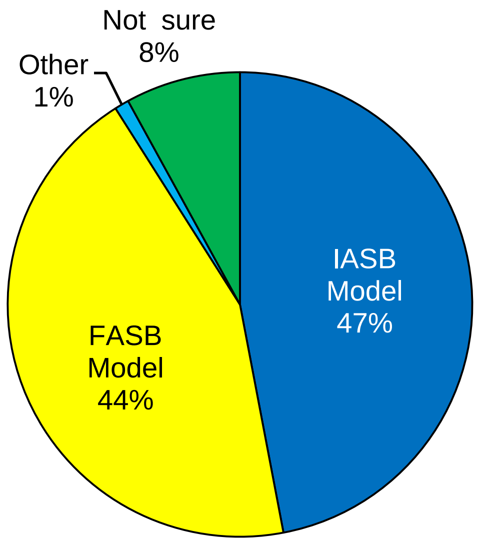
- *Both current fair value (market value if possible) and expected loss should be disclosed. For full transparency the reasoning behind expected loss should also be disclosed.*

- *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.*

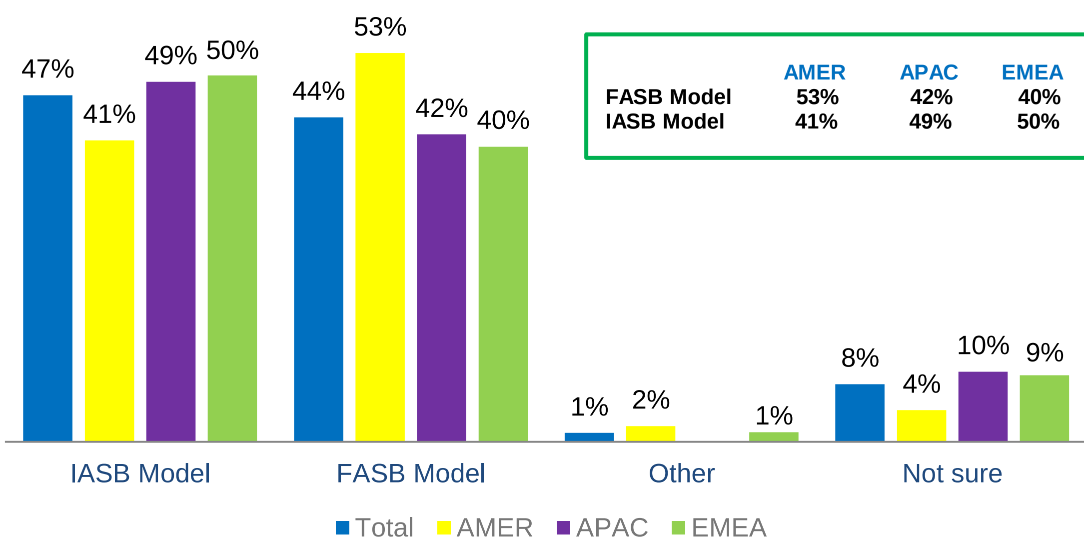
- *Too subjective and too late for the incurred loss model. Too subjective with management's estimates for expected loss model. Fair value has both elements of subjective and objective which is much more defensible in terms of future litigation.*

Preferred Expected Credit Loss Model

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



Regional Breakdown



	AMER	APAC	EMEA
FASB Model	**53%**	**42%**	**40%**
IASB Model	**41%**	**49%**	**50%**

Preferred Expected Credit Loss Model

Observations

- **IASB Model Preferred:** Investors have a slight preference for the IASB model (47%). This support was based on the investor view that it reflects a more economic representation. Major criticism of IASB Model was that 12 months of losses was considered arbitrary.

- **FASB Model Preferred for Prudence:** Investors favoring the FASB model (44%) indicated that this was driven by their preference for prudence.

- **Regional Preference:** There were clear regional preferences with EMEA and APAC supporting the IASB model (49-50%) and the Americas region supporting the FASB model (53%).

Respondent Comments

- *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.*

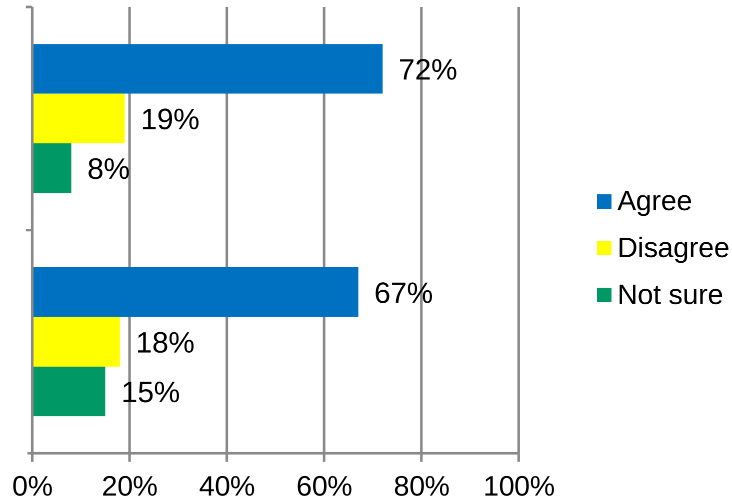
- *The FASB model is the most prudent and is therefore the most acceptable.*

Time Value

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

Incorporate Time Value – The time value of money should be incorporated into the measurement of credit losses (i.e. the allowance for credit losses should be discounted). (N=342)

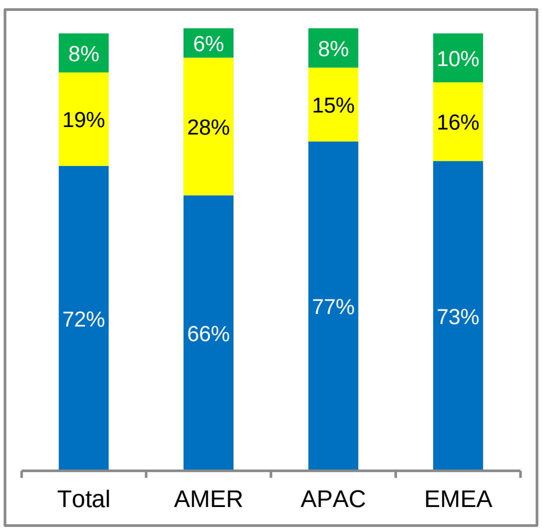
Explicit vs. Implicit Incorporation – The time value of money should be explicitly rather than implicitly (i.e. the time value is not specifically quantified) incorporated in the measurement of credit losses. (N=327)



Regional Breakdown

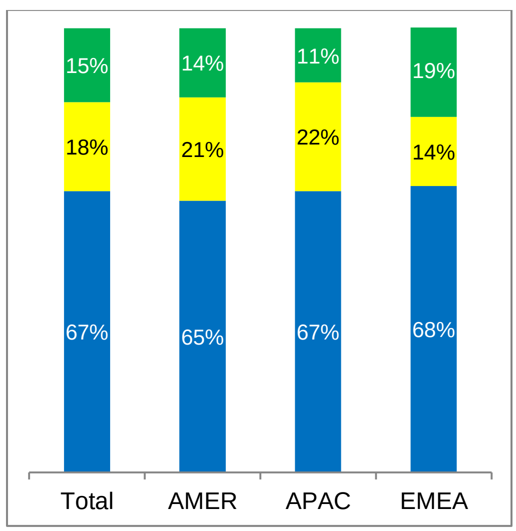
Incorporate Time Value

Americas region shows 10-15% lower support for discounting.



Explicit vs. Implicit Incorporation

Support was relatively even across regions for explicit incorporation. Greater clarity needed on implicit incorporation and how it works.



Agree Disagree Not sure

Time Value

Observations

- **Support for Discounting:** A strong majority of respondents (72%) supported discounting expected credit losses.

- **Support for Explicit Measurement:** Respondents also strongly favored (67%) that the time value of money should be explicitly rather than implicitly incorporated in the measurement of credit losses.

Respondent Comments

- *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.*
- *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.*
- *As implied in the comment above, financial readers interpret impairments as some form of valuation, therefore the time value of money concept should be explicit.*

Discount Rate

Which discount rate do you think is most appropriate for discounting expected credit losses? (N=358)

Effective Rate – The effective interest rate.

Rate Between Risk Free & Effective Rate – Any rate between the risk free rate and the effective interest rate – selected based upon management's discretion.

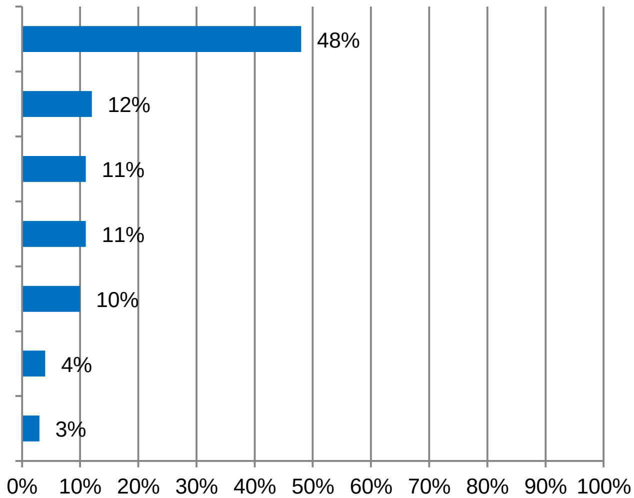
Risk Free Rate – The risk free rate.

Don't Discount – I do not believe the expected credit losses should be discounted.

Management Select & Disclose – A rate selected by management as long as it is disclosed.

Not Sure

Other



Observations

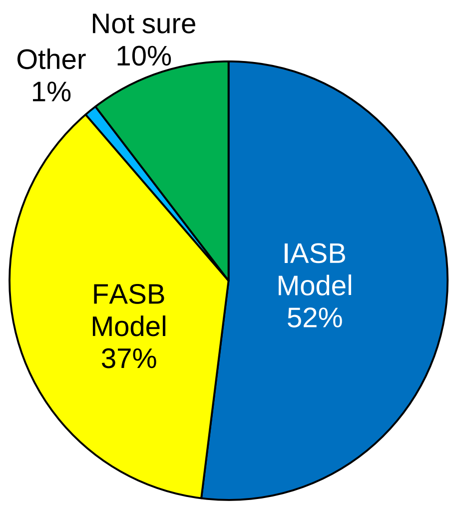
- **Effective Interest Rate Preferred:** Investors signal a clear preference for the effective interest rate as the most appropriate (48%). The risk free rate was not preferred (11%)
- **Rate at Management's Discretion Not Preferred:** Any rate between the risk free rate and the effective rate based upon management's discretion was clearly not preferred (12%).
- **Disclosure of Discount Rate is Essential:** Investors indicated disclosure of discount rate was essential.

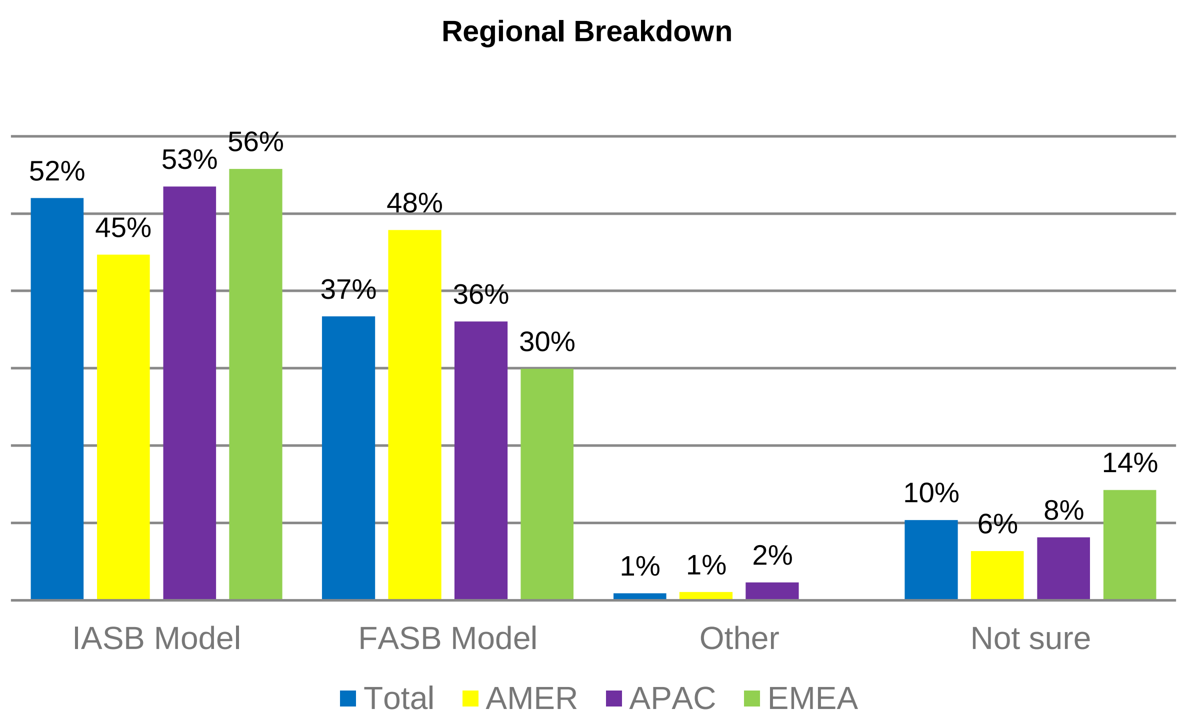
Respondent Comments

- *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.*

Interest Income

If different interest income recognition patterns are adopted, which model would you prefer? (N=327)





Interest Income

Observations

- **IASB Model for Interest Preferred:** The majority of respondents favor the IASB proposal (52%) for interest revenue recognition over the non-accrual approach proposed by the FASB.

- **Interest Income Recognition Pattern Needs to Be More Clearly Illustrated:** The pattern of interest income recognition under each model and the impact on comparisons of interest income across models needs to be more clearly illustrated and communicated to investors. This pattern is important to many investors and the FASB and IASB have not sufficiently articulated to investors the impact of the credit loss model on the interest income recognition pattern.

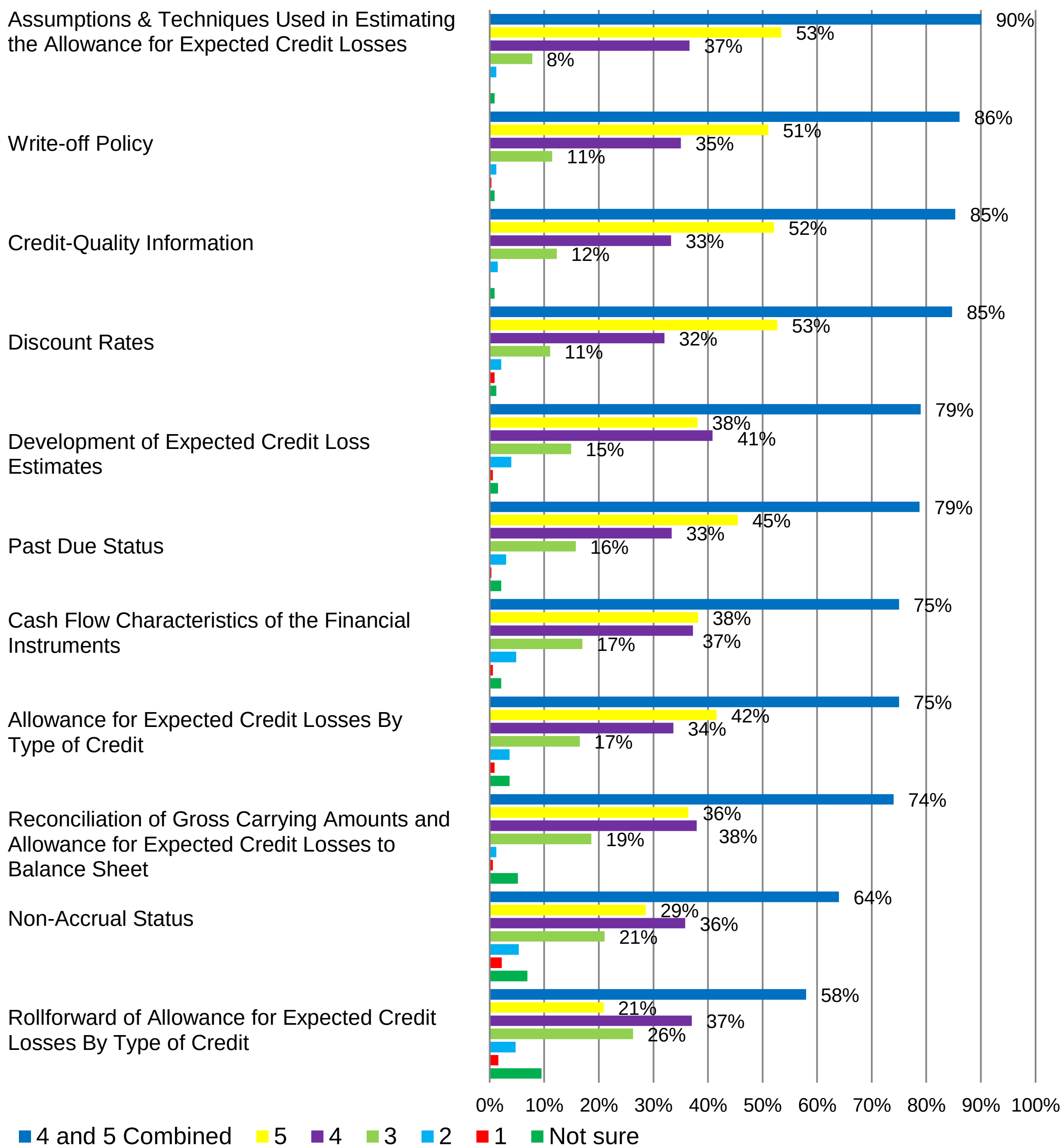
Respondent Comments

– *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.*

– *I like non-accrual guidance applied today by US banks. It works and we understand it. No need to change that.*

Financial Statement 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)

Financial Statement Disclosures

Observations

- **Most Important Disclosures:** Disclosures related to underlying assumptions and credit-quality were rated highest (e.g. assumptions & techniques, credit-quality information, write-off policy and discount rate).

- **Disclosures Essential to Investors Must Be Added to a Final Standard:** Disclosures <u>not included in the proposals</u> – including the development of expected credit losses (79%) and the cash flow characteristics of financial instruments (75%) – were very highly rated by investors. Such disclosures are essential to investors and must be added to a final standard.

Respondent Comments

- *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.*

- *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!*

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

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

About This Survey

CFA Institute conducted a survey of its membership to ascertain investor preferences related to financial reporting for credit losses. Because of the relationship between credit losses and interest rates, input was sought on several interest income related issues.

Methodology

The online survey was conducted from 27 June to 11 July 2013. A sample of global members (16,001) was invited to participate in the survey; 361 responded, for an overall response rate of 2% and a margin of error of +/- 5%.

About CFA Institute

CFA Institute is the global association of investment professionals that sets the standards for professional excellence and credentials. The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 117,000 members in 137 countries and territories, including over 109,000 CFA charterholders, and 138 member societies.

Questions

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