

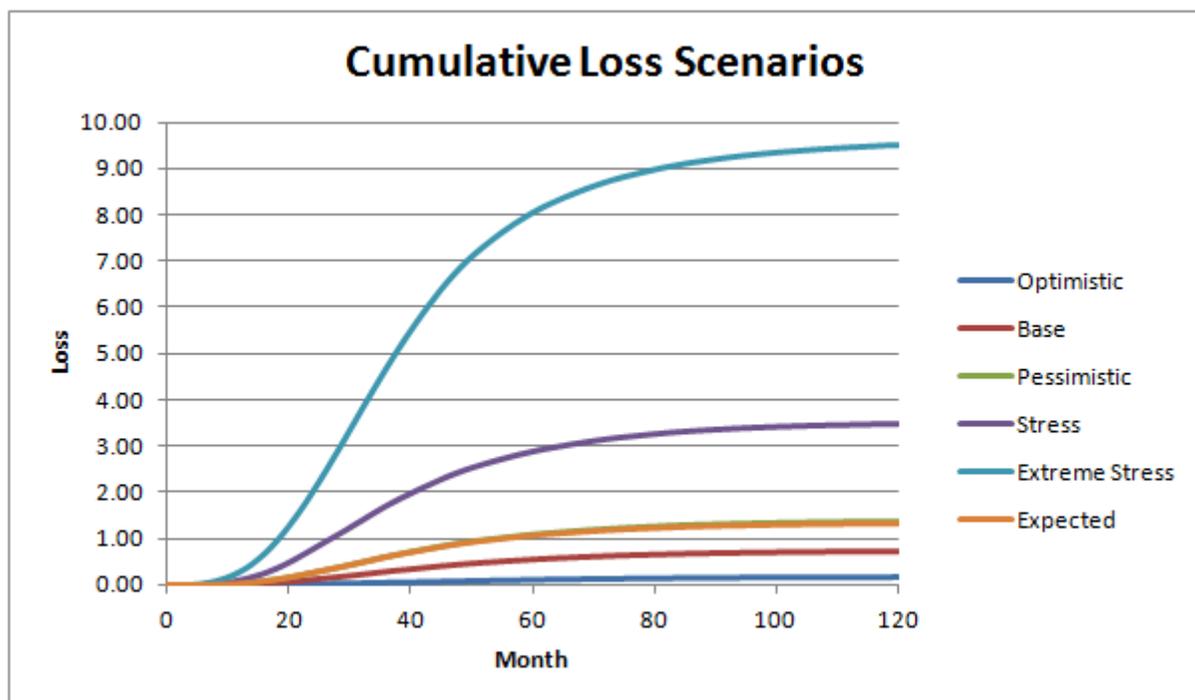
Proposed Accounting Standards Update

Financial Instruments—Credit Losses (Subtopic 825-15)

Thank you for the opportunity to comment on the proposed accounting standards update: **Financial Instruments—Credit Losses**. Andrew Davidson & Co., Inc. is a leading provider of prepayment models, credit models, and valuation tools to the mortgage investment community, and we have provided modeling and analytical support to a broad spectrum of financial institutions since 1992. Over the past several years we have worked with over 30 clients assessing the potential credit risk (impairment) and fair value in their non-agency ABS/MBS portfolios. We have also been involved in numerous meeting and conference calls with internal and external auditors. We appreciate the efforts of the Board and FAS staff to enhance and clarify the determination of credit losses. The comments below reflect our views only.

Recognition and Measurement

Before we answer the questions in detail, we would like to begin with an example of the types of scenarios that our clients and many other financial institutions are able to run. In the Figure below, we show cumulative losses for prime mortgage collateral, with forecasts starting in April 2013, for the first 120 months (the forecasts are available for 360 months). The base



case scenario, shown in red, is the scenario that is typically projected out for the next 4 quarters in current accounting of losses. On the other hand, for the computation of expected credit losses, the variability of losses across potential future economic environments is quite important. As this bond shows, the outcomes can be highly asymmetric and skewed. It is the skew in the distribution which results in the expected loss being on top of the Pessimistic scenario.

In the next table, we show the probability and cumulative losses for each of the scenarios, along with the computed expected loss. Note that the expected loss of 132 basis points (bps) is only 6 bps lower than the cumulative loss on the pessimistic scenario. Additionally, the difference between the base case scenario loss and the expected loss is 59 bps, which is about 80% of the base case loss.

Scenarios	Optimistic	Base	Pessimistic	Stress	Extreme Stress
Probability	25%	35%	25%	12.5%	2.5%
Loss %	0.18	0.73	1.38	3.47	9.51
Expected Loss	1.32				

The expected loss is computed as the weighted average of each of the scenario losses, weighted by the probabilities associated with the scenario, as shown in the table. Additionally, the line for expected loss in the graph is computed the same way, for each time period of the forecast period.

Many systems in use by risk managers and portfolio managers allow specific macro-economic scenarios, potentially including house price, interest rate and unemployment rate movements, to be input into models which drive the loss projections, and bond or loan pool losses to be forecast for each scenario as above, and aggregated.

Questions #2 and #3: Should initial recognition threshold of credit losses be replaced by the measurement of expected credit losses? Is the net present value of expected cash flows the appropriate measure?

We concur with the recommendation that credit losses should be viewed in the context of measurement rather than recognition. Incurred losses reflect events which have already taken place. Using this methodology, one calculates a rolling periodic (quarterly, for example) forecast of losses and recognizes credit losses on that basis. Therefore, multiple scenarios and projections have no role in the process.

In contrast, the use of expected life-time losses provides much more comprehensive information that can be used in decision-making. One can observe the expected evolution of credit losses over time using multiple scenarios—at least one of which will generate expected losses and will override the reliance on “base case” scenarios. The expected present value of future cash flows would be the correct measure to be used. Any expected cash flow shortfall would be recognized much earlier than under the incurred-loss approach. Therefore, the quarterly reporting should result in fewer “surprises” to management and more effective decision-making.

Furthermore, we believe that there should be an “attribution” approach to changes in expected credit losses. Each period, there will be changes in the composition of the portfolio, different macroeconomic assumptions (housing prices and interest rates), and changes in key data fields such as updated CLTVs. This attribution analysis would further enhance management’s understanding of the institution’s credit risk profile.

Question #4: Should expected credit losses reflect all expected credit losses rather than a short-term horizon?

We believe that the entity should recognize all expected credit losses, consistent with the proposal. Currently, the standard is incurred losses over 12 months. However, any short-term horizon is arbitrary. Management decision-making and reporting benefit from a more complete picture of expected credit performance. Again, this would result in fewer “surprises” given the seasoning pattern of credit risk.

There are two related issues. The first is the choice of scenarios on which to determine expected credit losses. The recommendation is that at least one scenario must show credit losses. However, the assumptions and methodologies for the selected scenarios must be explicit for internal and external review. The proposed methodology does not require probability weighting. We would recommend otherwise. Perhaps multiple scenarios that are probability weighted (such as the NAIC methodology) would provide considerable insight. However, this must be weighed against the cost and time required for some smaller institutions to model credit losses on this basis. Another possible approach would be equivalent to the Fed’s stress tests with base case projections coupled with stress analysis.

The second issue has to do with the measurement of the expected credit loss. The present value of expected cash-flows must be computed on a consistent basis. This obviously ties into #3 above, which is the calculation of net amortized cost discounted at the “effective” interest rate. There must be strict definitions on these elements.

Question #5: Should the estimates of expected credit losses be derived from historical loss experience, current conditions, and reasonable and supportable forecasts among other factors?

The proposed amendments require a rigorous approach to estimating expected credit losses. Obviously, the larger and more sophisticated institutions currently use historical loss experience and related models that are linked to reasonable macroeconomic forecasts. If not, such institutions should adopt such procedures as soon as possible.

The larger question has to do with smaller institutions. What is cost effective for such entities and what are the size cut-offs? At the minimum, there should be a transition period for these institutions.

Question 6: Should discounts be marked up in cost basis for expected losses?

First of all, we believe that the issue of whether a security is a discount or a par security has little to do with the issue of having an expected-loss adjustment. A securities discount or premium status is both a

function of the level of interest rates relative to the securities coupon (and in particular how much interest rates have changed since origination) and of discounts for expected credit losses and any market credit risk premium. If the security was purchased in a period of normally functioning markets, the cost basis (which is the market-traded price) would already reflect expected losses and a normal level of credit risk premium. Over the life of the security, if the expected scenario occurred, the only gain that would result is the capture of the credit-risk premium. Any deviation from the expected scenario would be reflected over time both through the cash flows received and through the market price as the market-updated expectations relative to the initial expected loss. We therefore see no reason for discount (or any other securities) to be marked up for expected losses.

Question 11: Should multiple scenarios and probability weighting be used?

We agree with the approach of multiple scenarios. Most loans and bonds have some scenarios where they experience very low losses and other scenarios with much higher losses. Not acknowledging this reality puts accounting on a very different footing from other applications which utilize this point of view, such as risk-based capital assignment, portfolio management and strategy. With even three to five well-spaced scenarios, it is much more likely that highly volatile bonds across the scenarios will have their expected losses captured more accurately than the use of a single scenario or path. This is because convexity or other structural features that are scenario-specific could remain hidden on that single path.

The separate issue of probability weighting is a relatively minor choice compared to the ability to generate cash flows along multiple paths. While allowing the use of probability weightings appears more general, in practice using particular un-weighted scenarios can achieve a very similar result. In general, we believe that once models are in place to run cash flows accurately over multiple scenarios, the majority of the difficulty has been overcome; applying different weights or the same weights to those scenarios is a relatively minor issue that should be easy to accomplish.

Questions 12 and 20: Will running multiple time vectors require a period of adjustment on the part of financial institutions? Is a transition period needed?

Sophisticated institutions are already using time vectors and models of loss by month outside of the accounting function. For the purposes of valuation and risk-based capital, they are already running multiple scenarios and have schemes in place to generate appropriate discount factors as well. These mechanisms could easily be adapted for accounting purposes, while keeping the number of paths relatively small. Less sophisticated institutions or those whose portfolios have changed a lot in the recent past may, however, need a period of time to adapt, as they may acquire certain models or extend the coverage of their existing models.

With any significant change, however, it is always important to have a transition period where results are run in parallel using previous methods and new methods. This will both help institutions understand differences between the approaches and iron out any bugs that may arise in the new processes.