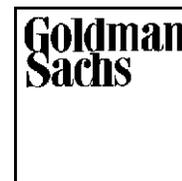


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Matthew L. Schroeder  
Managing Director  
Global Head of Accounting Policy



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September 1, 2010

Mr. Russell G. Golden  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update – Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815) (File Reference No. 1810-100)

Dear Mr. Golden:

Goldman Sachs appreciates the opportunity to comment on the above captioned Proposed Accounting Standards Update (the “ASU”). We support the overall efforts of the Board as it develops standards that generally require the increased use of fair value in financial reporting. We also support the Board in its joint efforts with the IASB as the Boards attempt to develop converged standards in the complex areas addressed by the ASU. In the General Comments section of this letter, we provide our perspective on the debate regarding the wider application of fair value accounting as proposed in the ASU. In our Detailed Comments section, we provide our support for the Initial Measurement Principle outlined in the ASU and disagree with the proposals in the ASU relating to liabilities that are not held for trading and measuring the effects of changes in a liability’s credit risk. Finally, we provide our perspective on core deposit liabilities and impairment.

### **General Comments**

The debate surrounding the use of fair value in the accounting for financial instruments is long-standing. The debate centers on non-hybrid loans and investments that are asserted to be held for the collection of contractual cash flows and not for trading, which many refer to as the “banking book.” Most would agree the current accounting and disclosure

model for the banking book is a maze of complexity in need of significant reform. We also agree with that sentiment.

More importantly, the current model does not provide investors in large, complex financial institutions with an accurate picture of a company's financial position and does not foster sound risk management. This latter point is crucial, as poor risk management was at the heart of the financial crisis. Firms that do not follow a fair value through net income ("FV-NI") model often must evaluate the trade-off between optimal risk management decisions and the financial statement consequences of their actions. Those consequences often are negative and can result in poor risk management decisions. The consequences of such decisions can have a significant effect on financial stability.

Goldman Sachs has long advocated a FV-NI model for financial assets and trading liabilities because it provides a clear picture of our financial position and because it fosters sound risk management which benefits the broader financial system. Consequently, this would be our first choice in developing a new accounting model for financial instruments. We recognize, however, that this is a minority view that also is not achievable at the current time. Faced with these realities, we are supportive of the ASU and believe it is a good compromise for the banking book because the balance sheet would reflect fair values and impairments would be recognized sooner than the current incurred loss model. Additionally, investors, regulators and other financial statement users would have the information necessary to understand the balance sheet and income statement impacts of the changes in value of the banking book assets.

We understand there are many constituents who believe the ASU represents an unnecessary change. We believe banking book fair values do not belong on the back pages of financial reports, where their prominence is diminished and the robustness of the valuations is a legitimate cause for concern. Fair values should be recognized on the balance sheet. If recognition of banking book fair values on the balance sheet ultimately is not achievable, our next preference would be parenthetical disclosure on the balance sheet.

Other constituents object to the ASU on the grounds that it would have a "pro-cyclical" effect on financial institutions' capital ratios (i.e. it would impair their capital ratios during an economic downturn, and thereby exacerbate it). This argument does not account for important differences in the objectives of financial reporting and regulatory capital standards for financial institutions. For example, the pending "Basel III" regulatory capital standards recognize the need to de-couple financial reporting and regulatory capital requirements by incorporating rules that are designed to be counter-cyclical (e.g., by establishing heightened capital requirements during periods of growth and lower thresholds during recessionary periods). Likewise, there are numerous adjustments to GAAP financial statements in calculating regulatory capital metrics under current and proposed standards.

Fair values are relevant because they inform management's view about the timing and amount of future cash flows that are subject to interest rate, credit and other market risks.

Asset values do reflect the price of liquidity and we believe it is entirely appropriate to account for changes in the price of liquidity, along with changes in interest rate, credit and other market risks, as proposed by the standard.

## Detailed Comments

### Classification and Measurement of Financial Assets and the Initial Measurement Principle

#### *Accounting Analysis:*

We support the proposed guidance in the ASU that addresses the *Initial Measurement Principle* (paragraph 12-17). This guidance is relevant and appropriate without regard to the broader debate concerning the more widespread application of fair value accounting because it fixes a gap in the current accounting rules surrounding the banking book, sales incentives and multiple element arrangements (Accounting Standards Codification (ASC) 605-25, *Revenue Recognition: Multiple-Element Arrangements*.)

This is not a situation that typically affects small banks. It is a one-time measurement requirement designed to identify situations where there is evidence that one transaction was entered at an off-market rate to secure other benefits related to the relationship and/or a second transaction between the same counterparties: specifically, the linkage between lending and investment banking often described as “relationship lending.”

Some constituents will maintain that ample guidance already exists in the accounting literature to address multiple element arrangements. However, as described in the following paragraphs, the current rules are deficient when lending and investment banking activities are linked.

ASC 605-25-30-4 states, “To the extent that any separate unit of accounting in the arrangement ... is required ... to be recorded at fair value (and marked to market each reporting period thereafter), the amount allocated to that unit of accounting shall be its fair value.” Because the banking book is not recorded at FV-NI, sales incentives and pricing discounts are not properly recorded, resulting in overstated investment banking revenues.

This is further exacerbated by the application of the rules in ASC 835-30, *Interest: Imputation of Interest*. In particular, ASC 835-30-15-3d states that the guidance for the imputation of interest and determining premiums and discounts on loans does not apply to “The customary cash lending activities and demand or savings deposit activities of financial institutions whose primary business is lending money.” We fully support the Board’s proposal in the ASU in paragraphs 12-17 to plug this gap in the existing accounting rules impacting large, complex financial institutions.

In the next section, *Current Market Conditions*, we describe some typical examples that illustrate the frequency and nature of relationship lending. Our issue is not with

relationship lending by itself but rather, that the accounting needs to reflect the substance of the transaction.

*Current Market Conditions:*

It is common practice for borrowers to require that a bank participate in the borrower's revolving credit facility ("revolver") and/or the borrower's funded term loan ("term loan") as a condition of receiving future underwriting business. In many situations the borrower will be very explicit and inform the bank that it will not be permitted to participate in future underwriting business without participating in these "relationship loans." In some situations, the bank will also be required to participate in a relationship loan in order to participate in future financial advisory assignments (such as a merger transaction) or obtain asset management business from the borrower (e.g., managing its cash balances).

Borrowers frequently condition future underwriting and advisory business on relationship loans because, without this incentive, they would be unable to obtain these loans on advantageous terms. In other words, borrowers are using the fees and other benefits associated with contemporaneous or future underwriting and advisory transactions to induce banks to make term loan commitments even though the terms of such relationship loans are off-market.

The demand for relationship loans as a condition to participating in future business has become even more prevalent over the past several years. Today, in many initial public offerings ("IPOs") that involve a company with a significant amount of debt, or the need for a revolving line of credit, the company will often require a loan commitment from any underwriter that wants to have a significant role in the offering. Likewise, for investment grade borrowers who access the commercial paper market, banks will generally be required to commit to the borrower's back-up credit lines in order to participate in future bond offerings by the issuer. Many companies refuse to execute any business with banks that do not provide credit extension.

To illustrate this phenomenon, if one looks at a list of recent and pending IPOs involving companies with significant bank debt, there will generally be symmetry between the lead underwriters for the IPO and the composition of the banks in the company's credit facility and term loan. In many transactions, the fees generated by each bank for underwriting the IPO generally will be proportionate with their lending commitments.

The "lend to play" practice is equally prevalent in the case of public companies that demand relationship loans from banks in order to participate as an underwriter in their future debt offerings. Many public companies will generally not invite a bank to serve as an underwriter without receiving a significant lending commitment from such bank.

In these relationship loan situations, it is generally clear, based on discussions with the borrower and the terms of the arrangements, that the bank making the loan has reason to believe there is a significant difference between the contract price and the fair value of such loan or loan commitment and there is reliable evidence to support this difference. In

addition, in these situations there will clearly be “other elements” present, notably the expectation of other fees the bank will earn by participating in such a relationship loan. In other words, there is a clear link between banks that are willing to extend credit on off-market terms in order to capture the future fees related to various underwriting and other financial advisory activities.

In the Appendix to this letter we have included two examples, modeled on actual transactions, of the “lend to play” phenomenon and described methodologies by which an appropriate fair value can be determined in those circumstances.

#### Clarification of the Application of the Initial Measurement Principle

With reference to the implementation of the initial measurement guidance, paragraph IG11 states that, “... the financial instrument should be initially recognized at its fair value in accordance with the fair value measurement guidance in Topic 820 *or Subtopic 835-30 if a present value technique is used*” (*italics added.*) We believe that the fair value measurement guidance in Topic 820 should be used in all circumstances to ensure consistency of application. It is unclear as to why an alternative is included or in what circumstances the Board believes the alternative to be preferable.

#### Classification and Measurement of Financial Liabilities

As noted above, we have long advocated a FV-NI model for financial assets and trading liabilities, for example, short positions and derivative liabilities.

We agree with the primary message the IASB reached from its outreach program, that is, “the effects of changes in a liability’s credit risk ought not to affect profit and loss unless the liability is held for trading. That is because an entity generally will not realize the effects of changes in the liability’s credit risk unless the liability is held for trading.”<sup>1</sup>

We appreciate this is an asymmetrical view but it is consistent with another message the IASB received from its outreach, that is, “symmetry between how an entity classifies and measures its financial assets and its financial liabilities is not necessary and often does not result in useful information... the Board should not be constrained or biased by the requirements... for financial assets.”<sup>2</sup>

At a practical level, the issue presents itself primarily in structured notes and unsecured long-term debt we issue. Structured notes are issued to a diverse group of investors, in different regions, and with a variety of underliers. The ability to realize changes in a structured note’s credit risk is often limited to cases where an investor no longer desires the exposure the note provides and requests that the note be redeemed prior to maturity. In such cases, we believe the IASB’s model – bifurcation of embedded derivatives with a fair value option overlay that records changes in own credit in OCI– is superior to a

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<sup>1</sup> International Accounting Standards Board Exposure Draft *Fair Value Option for Financial Liabilities* (the IASB ED) paragraph BC7.

<sup>2</sup> IASB ED paragraph BC8(a).

model that would require all changes in a liability's credit risk be recorded in net income or other comprehensive income.

The issues are more pronounced with unsecured long-term debt. We support the amortized cost approach for these liabilities which provide long-term sources of liquidity and are settled at their contractual maturity in almost all cases.

#### Measuring the Effects of Changes in a Liability's Credit Risk

The FASB proposes to exclude changes in the general price of credit in the measurement of own credit in an effort to more precisely identify the changes in fair value due to own credit (that is, to exclude changes in fair value attributable to changes in the demand for liquidity.) This represents a change from the position taken upon the adoption of FASB Statement No. 159 when such a breakout was not required. IFRS 7 also attributes all changes in fair value, other than changes in a benchmark interest rate, to changes in the credit risk of the liability. We agree with the approach taken in IFRS 7.

These are complex issues that do not easily reduce to single measures. We are concerned that the Boards' attempt at precision may prove illusory. We do not believe it is practical to separate changes in own credit from the overall price of credit. On balance, therefore, we consider the IASB's proposed model to be preferable because it is simpler and operationally easier to apply, which should lead to greater comparability.

#### Core Deposit Liabilities

Some constituents do not agree that fair values for financial assets are relevant because they have access to stable sources of funds (core deposits) and believe they will maintain those sources in difficult funding environments. While that is often the case, funding sources can change unexpectedly and, when they do, the consequences are usually negative.

The ASU attempts to reconcile the differing views by requiring entities to record the value of their core deposits on the balance sheet, with changes recorded in other comprehensive income along with changes in the value of the banking book. This compromise comes at the cost of piecemeal recognition of an internally generated intangible asset. Therefore, our preference would be to address the issue of internally generated intangible assets in a separate, comprehensive project. However, we understand the Board's compromise which provides support for the recognition of the banking book at fair value. If recognition of banking book fair values on the balance sheet is ultimately not achievable, then this proposed guidance should be abandoned.

### Impairment and Interest Income Recognition

We note that both the FASB and IASB have each proposed new provisioning rules that result in the recognition of impairments sooner than under the current models. We support the efforts of the Boards as they work to develop standards that ensure that bank provisioning is recorded timely in the financial statements. The impairment models proposed by both the FASB and IASB generally will require the projection of cash flows with the IASB's model incorporating more forward-looking information. We believe provisioning should incorporate forward-looking information that is reasonable and supportable. Changes in expectations of future cash flows also impact interest income recognition. We favor a model that immediately recognizes yield adjustments and does not defer their impact to future periods.

Thank you for the opportunity to provide our views. If you have any questions or comments regarding this letter, please do not hesitate to contact me at 212-357-8437.

Sincerely,

A handwritten signature in cursive script that reads "Matthew L. Schroeder".

Matthew L. Schroeder

## **Appendix: Real World Examples of the “Lend to Play” Phenomenon**

### **Example #1: Banks Required to Commit to Credit Facility to Participate in Underwriting and IPO**

#### *Background*

The following is a typical example of a transaction involving an IPO where the company going public required the banks competing for the IPO business to commit to a credit facility in order to participate as an underwriter in the IPO. We have not used actual names in this example, have simplified some facts and rounded off some of the figures in order to avoid disclosing any non-public information.

Company X is a private company owned by a group of financial sponsors (“Sponsors”). Company X solicited a number of large banks to serve as underwriters in its IPO. The solicitation process included a formal “request for proposal” (RFP) which included a number of specific questions and requirements that the banks had to address during their “pitch.” One of the requirements in the RFP was for each bank had to commit to a 3 year extension of an existing revolving credit facility (“Revolver”) that was set to mature in 2.5 years time in order to have a significant role in the IPO. There were minimum commitment sizes based on the title awarded to each bank, and a bank that did not make this minimum commitment would not be considered a candidate for a significant role in the IPO regardless of its qualification.

The expected size of the IPO was \$5 billion, although the actual size could have been larger or smaller depending upon a variety of factors, including market conditions at the time of the offering. The total fees payable to the underwriters in the IPO was estimated to be approximately \$175 million (or 3.5% of deal size). In addition, the underwriters in the IPO would be in an advantageous position to serve as the underwriters for any future follow-on equity offerings as the Sponsors sell down their retained stake in Company X. These underwriters would also be likely to lead future bond offerings for Company X and would be well positioned to earn other advisory fees (e.g., for merger transactions). Thus, the total fee potential for the underwriters is significant, but they can only participate in earning those fees if they also commit to the Revolver.

Company X has significant outstanding debt and has a non-investment grade credit rating from the major credit rating agencies. The total size of the extended Revolver is \$2 billion and substantially all of this commitment will be sourced from banks that are underwriters in the IPO.

#### *Key Terms of the Extended Revolver*

The key terms of the Revolver are as follows:

- Maturity: 5.5 years
- Upfront fees: 0.0% of commitment amount
- Annual fees for undrawn amounts: 0.5%
- Interest rate on drawn amounts: floating rate equal to one-month LIBOR plus a spread of 2.75% (L + 275)

- Security: any amount drawn on the revolver will be secured by most of Company X's assets
- Covenants: the Revolver will contain both "incurrence" and "maintenance" covenants. The covenants are generally less restrictive than the covenants that would likely have been demanded if the Revolver was sourced from third party lenders that were not induced to participate in the Revolver by the opportunity to earn underwriting fees associated with the IPO and other transactions.

#### *Fair Value of the Revolver*

In this situation, there is reliable evidence that the fair value of the Revolver is significantly less than the contract price (i.e., the Revolver commitment represents a net liability at the contract date). However, the banks participating in the Revolver are willing to participate because of "other factors," specifically the other fees they expect to earn in connection with the IPO and subsequent underwriting and advisory transactions.<sup>3</sup>

There are several forms of reliable evidence to calculate the fair value of the Revolver at the contract date.

#### *Method One: Comparing Undrawn Fee to Credit Spread on Funded Loan*

One method to estimate the fair value of the Revolver involves comparing the interest rate charged by the lenders on amounts borrowed under the Revolver relative to the annual fee on undrawn amounts. A lender under the Revolver is exposed to Company X's credit risk even if the Revolver is undrawn because an undrawn commitment represents an obligation to lend to Company X through the maturity day of the Revolver. In other words, the undrawn Revolver is similar to a bank writing a credit default swap on Company X's credit since the bank has been exposed to Company X's credit risk without actually funding a loan.

Given that the underlying index (i.e., LIBOR) represents an approximation of a risk-free rate, one can think of the interest rate on drawn amounts to represent a credit spread of 2.75%. However, the lender under the Revolver is only receiving an undrawn fee of 0.5% to take credit risk on undrawn amounts which equates to at least 2.25% per year less than an arm's-length rate. Over five and a half years, this represents approximately 8.8% on a present value basis net of all fees.

#### *Method Two: Comparing Undrawn Fee to Cost of Credit Default Swaps*

A second method that can be used to calculate the fair value of the Revolver is to look at the cost of purchasing insurance against a default by Company X. Given that an unfunded Revolver is akin to writing credit default protection, a lender can hedge its exposure by purchasing insurance in the form of loan credit default swaps (LCDS). This would put the lender in a "neutral" position since any loss incurred by the bank on the Revolver as a result of a default (relating to amounts drawn prior to default) would be offset by the "gain" on the LCDS that it purchased.

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<sup>3</sup>As discussed above, under current accounting rules, participants that hold the Revolver in their "banking book" would not properly record the pricing discount thereby overstating their investment banking revenues.

At the time the Revolver was entered into, Company X had senior secured LCDS contracts that provided holders with protection on debt obligations with the same level of seniority as the Revolver. The cost of purchasing a 5-year LCDS was approximately 2.6% per year. Accordingly, a bank participating in the Revolver that wanted to hedge its risk could purchase LCDS protection in an amount equal to its Revolver commitment.

The cost of purchasing this protection for 5.5 years (on a present value basis) would be approximately 10.2% of the Revolver commitment whereas the upfront and ongoing fees associated with the Revolver commitment total 2.0% on a PV basis. Accordingly, under this hedging approach, the fair value of a Revolver commitment illustrates an upfront cost of approximately 8.2% of the notional commitment.

#### *Conclusion*

Based on the above methodologies, the fair value of the Revolver is approximately 91-92% of the notional commitment amount. This would imply an upfront loss of approximately \$8-9 million for a bank that agrees to a \$100mm commitment. Under current accounting rules, banks that hold their Revolver commitments in their “banking book” would not properly record the pricing discount even though the Revolver commitment was made on these borrower-friendly terms with the expectation that such lending would create other opportunities to generate fees for the lending bank.

## Example #2: Banks Required to Commit to Credit Facility to Participate in Underwritten Bridge to Bond Financing

### *Background*

The following is an example of a transaction involving a bridge to bond financing, where the company issuing bonds required the participating banks to commit to a credit facility. We have not used actual names in this example, have simplified some facts and rounded off some of the figures in order to avoid disclosing any non-public information.

Company Y is a public company with a market cap greater than \$20bn. Company Y solicited a number of large banks to participate in a senior unsecured notes offering, backstopped by an underwritten term loan commitment. The underwriting banks were also required to commit to a portion of a new revolving credit facility (“Revolver”) in an amount pro-rata to their commitments under the backstopped notes offering.

The expected size of the notes offering was \$1.5 billion. The total fees payable to the participating banks was estimated to be approximately \$60 million (or 4% of deal size, including commitment fees on the term loan backstop). In addition, the underwriters of the facilities would be in an advantageous position to participate in additional expected bond refinancings with Company Y, as well as earn advisory fees in connection with expected future M&A opportunities. Thus, the total fee potential for underwriters is significant, but they can only participate in earning those fees if they also commit to the Revolver.

Company Y has significant outstanding secured and unsecured debt and has a corporate credit rating that is split investment grade / high yield from the major credit rating agencies. The total size of the Revolver is \$5 billion, with all of this commitment sourced from banks participating in the backstopped bond issuance. The tranche rating of the revolver is expected to be investment grade from all of the major credit rating agencies.

### *Key Terms of the Revolver*

The key terms of the Revolver are as follows:

- Maturity: 5 years
- Upfront fees: 3% of commitment amount (1.5% upfront fee + 1.5% underwriting fee)
- Annual fees for undrawn amounts: 0.5%
- Interest rate on drawn amounts: floating rate equal to one-month LIBOR plus a spread of 2.75% (L + 275)
- Security: any amount drawn on the revolver will be secured by most of Company Y’s assets

### *Fair Value of the Revolver*

In this situation, there is reliable evidence that the fair value of the Revolver is significantly less than the contract price (i.e., the Revolver commitment represents a net liability at the contract date). However, the banks participating in the Revolver are willing to participate because of “other factors,” specifically the other fees they expect to

earn in connection with the backstopped notes offering and subsequent financing and advisory transactions.<sup>4</sup>

*Comparing Undrawn Fee to Credit Spread on Funded Loan*

One method to estimate the fair value of the Revolver involves comparing the fair spread on a funded term loan to the economics under the Revolver. The banks committing to Company Y's Revolver had also backstopped the note issuance with a term loan commitment, which was indicated to clear the market at L+400 bps. The Revolver, on the other hand, was committed at L+275 bps drawn / 50 bps undrawn.

Given that the underlying index (i.e., LIBOR) represents an approximation of a risk-free rate, one can think of the interest rate on the term loan to represent a fair credit spread of 4.00%. However, the lender under the Revolver is only receiving an undrawn fee of 0.5% to take credit risk on undrawn amounts which equates to at least 3.50% per year less than an arm's-length rate. Over five years, this represents approximately 9.77% on a present value basis net of all fees.

*Conclusion*

Based on the above, the fair value of the Revolver is approximately 90% of the notional commitment amount. This would imply an upfront loss of approximately \$10 million for a bank that agrees to a \$100mm commitment. Under current accounting rules, banks that hold their Revolver commitments in their "banking book" would not properly record the pricing discount even though the Revolver commitment was made on these borrower-friendly terms to generate other fees for the lending bank.

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<sup>4</sup>As discussed above, under current accounting rules, most of the revolver participants would record the revolver at the initial contract price (i.e., no gain or loss) because they will hold the Revolver in their "banking book."