



Letter of Comment No: 63  
File Reference: 1250-001

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April 12, 2006

Mr. Larry Smith  
Director – Technical Application and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856

**Re: File Reference No. 1250-001, Proposed Statement of Financial Accounting Standards,  
*The Fair Value Option for Financial Assets and Financial Liabilities***

JP Morgan Chase & Co. (“JPMorgan Chase” or “the Firm”) appreciates the opportunity to comment on the Financial Accounting Standard’s Board’s (“FASB” or “the Board”) Proposed Statement of Financial Accounting Standard *The Fair Value Option for Financial Assets and Financial Liabilities* (the “Exposure Draft”).

We strongly support the Board’s efforts and encourage the Board to move forward with the various planned Phases of the project. We believe the Exposure Draft, as written, successfully accomplishes the Board’s stated goals. The Exposure Draft provides entities a means by which to eliminate certain volatility in earnings that results from using different measurement attributes. As a result an entity may provide the readers of the financial statements with a better representation of the economics of certain activities and can do so without having to apply complex hedge accounting provisions.

We believe Phase I is a significant first step in providing a fair value option. Below, we have outlined an additional asset class for the Board to consider within Phase I of the project. We have also provided feedback regarding items for the Board to consider in Phase II.

**Phase I- Physical Commodities Inventories**

We understand that it was the Board’s intention to address nonfinancial assets and nonfinancial liabilities in Phase II of the fair value option project. Having said that, we believe that physical commodities inventories should be considered within Phase I. Our view is based on the following:

- Physical commodities inventories have risk characteristics similar to financial assets that are included within the scope of the Exposure Draft. Physical commodities inventories are subject to financial risk (principally due to changing prices); are often actively risk managed as part of an entity’s broader trading operations; and in many cases have market observable values.
- Mixed practice exists regarding the appropriate application of US GAAP to physical commodities inventories. Practice differences arise from differing interpretations of

EITF Issue No. 02-03, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*; ARB 43, *Restatement and Revision of Accounting Research Bulletins*; and, the AICPA Audit Guide, *Brokers and Dealers in Securities*. Depending on one's interpretation of the relevant GAAP, physical commodities inventories should either be marked to market through earnings in accordance with the Broker-Dealer Guide or accounted for on a lower of cost or market basis in accordance with ARB 43.

We strongly believe that the fair value option election should be made available for physical commodities inventories as it would eliminate earnings volatility that certain entities are exposed to due to a mixed attribute model as well as enhance comparability amongst entities with similar economic strategies.

As we believe that deliberation associated with inclusion of physical commodities inventories would be limited and these inventories have characteristics similar to financial assets, we request that they be included within the scope of Phase I of the project.

### **Phase II - Written Loan Commitments and Demand Deposits**

One of the primary objectives of the fair value option election is to mitigate mismatches associated with the mixed attribute accounting model. Two prominent examples of this mismatch are in the risk management of credit instruments and demand deposits. While we understand the Board's desire to defer certain financial instruments to Phase II we believe that these are important issues that need to be addressed and can be resolved outside of the broader debate of a fair value election for nonfinancial instruments. Therefore we recommend that the Board address these items as a first sub-phase of Phase II of the project.

### **Credit Risk Management and Written Loan Commitments**

An entity will often hedge its exposure to credit events arising from the extension of credit facilities which include both a funded and an unfunded component. These facilities are accounted for on an accrual basis whereas the hedging instrument is accounted for at fair value. Allowing the fair value election for both components of the facility will mitigate some of the accounting mismatch.

To further address the mismatch for credit hedges one must consider the practical realities of credit risk management. Upon origination of a facility an entity may choose to hedge a certain amount of exposure to a borrower but may not hedge the entire amount of exposure to the borrower. In other cases no hedging will be undertaken at inception, but instead when a concentration arises (from subsequent transactions) or there is deterioration in the credit against which the entity wishes to be protected. While we agree that designation of an instrument/contract should only be allowed at inception, we believe that the Board should consider allowing the designation of a proportion of a financial instrument at inception. This would further mitigate the accounting mismatch for credit hedges. We ask that the Board consider the following references in the existing literature related to proportionate designations.

Paragraph 18 of SFAS 133 states, in the context of a hedging relationship, that:

Either all or a proportion of a derivative may be designated as the hedging instrument. The proportion must be expressed as a percentage of the entire derivative so that the profile of risk

exposures in the hedging portion of the derivative is the same as that in the entire derivative.

Paragraph 21a of SFAS 133 states:

The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (*or a specific portion thereof*).....

Demand Deposits

In its deliberations around demand deposits in the initial stage of Phase II we ask that the Board consider the economic reality associated with these liabilities. The interest rate risk, and the expected maturity upon which it is based, is taken into account by the deposit-taking institution in its risk management practices, by rating agencies who monitor its liquidity, and by competitor institutions who seek to acquire its deposit base. While we recognize that the Board will need to deal with the complexity of valuing demand deposits and the related core deposit intangibles, we believe that the fair value of demand deposits would be meaningless without consideration of its significant nonfinancial component. Therefore we recommend that the Board consider the election of fair value for both the demand deposit and the related intangible within the first sub-phase of Phase II of the project.

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We appreciate the opportunity to comment and commend the Board on their progress in working toward implementation of a Fair Value Option for US GAAP. If you have any questions, please contact me at 212-270-7559 or Shannon Warren at 212-648-0906.

Very truly yours,

Joseph L. Sclafani