The World Bank

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Proposed Accounting Standards Update of Subtopic 825-10: Recognition and Measurement of Financial Assets and Financial Liabilities

Dear Sir / Madam,

The World Bank (the "Bank") appreciates the opportunity to comment on the FASB's Proposed Accounting Standards Update, Recognition and Measurement of Financial instruments *(proposed "Update").*

We acknowledge the considerable efforts of the FASB to create a comprehensive framework for the classification and measurement of the financial instruments within its scope.

In addition to being a user and preparer of financial statements, the Bank helps its members develop effective financial reporting systems to facilitate access to markets and foster economic growth.

While we agree with the FASB's objective of providing financial statement users with more decision-useful information about an entity's involvement with financial instruments, we believe the requirements of the proposed Update result in the following undesirable outcomes:

- The proposed Update reduces the relevance of U.S. GAAP in providing users with decision useful information because it results in an incomplete measurement of the characteristics of financial instruments and accentuates asymmetry in financial reporting through mixed attribute accounting. Specifically, the proposed Update prevents entities from recognizing and measuring financial information in a manner that reflects the true characteristics of the firm's financial instrument risk;
- We believe that the proposed Update provides an opportunity for the management of income (both inadvertently and/or proactively);

- Complying with the proposed Update requires significant resources to measure and reconcile financial information that will be used to meet U.S. GAAP requirements with financial information that will be used for decision-making purposes. Additional resources would be also required to interpret and apply the derivative rules in ASC 815;
- The additional operational risk of applying the ASC 815 derivative rules in determining what constitutes derivatives and the bifurcability of embedded derivatives will result in increased restatement risk for financial reporting.

We believe that the above issues will significantly affect the credibility and usefulness of U.S. GAAP and would be happy to engage with the FASB to discuss possible resolutions. The following discussion further elaborates our concerns and includes examples which illustrate our experience.

Financial Assets
Fair Value through Other Comprehensive income (OCI)

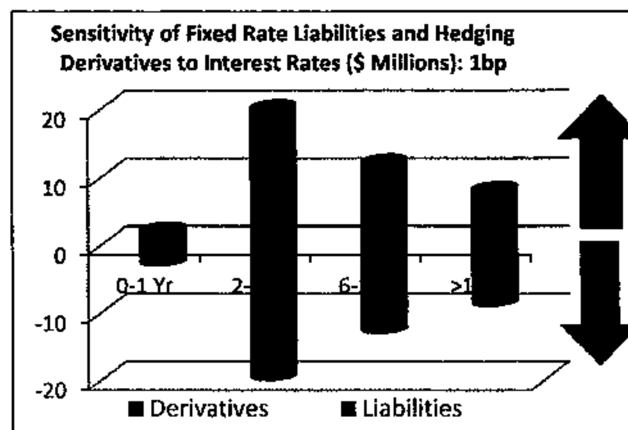
We note that the proposed Update currently allows financial assets, which are held purely for trading purposes, to be carried at fair value through net income. However, in instances where these financial assets are also held for liquidity management purposes it would appear that the current proposal would result in mixed attribute accounting, unless an entity is able to elect the fair value option. Specifically, if an entity uses derivatives to manage the currency or interest rate risks in its liquidity portfolio (consisting of plain vanilla bonds and hedging instruments), this proposed Update would require the plain vanilla bonds to be carried at fair value through OCI while the derivatives would be carried at fair value through net income.

This approach would reduce the relevance of U.S. GAAP financial statements as it does not report information in accordance with how an entity manages the liquidity portfolio and the related underlying risks.

Financial Liabilities
Under the current proposal, financial liabilities would be primarily measured at amortized cost.

For information, the Bank does not use hedge accounting because we believe fair value has the effect of surfacing hedge ineffectiveness transparently and in a less operationally risky manner. Hedge accounting is particularly ineffective when hedges are portfolio-wide.

Figure 1



Proposed ASU: Financial Instruments – Recognition and Measurement of Financial Assets and Financial Liabilities

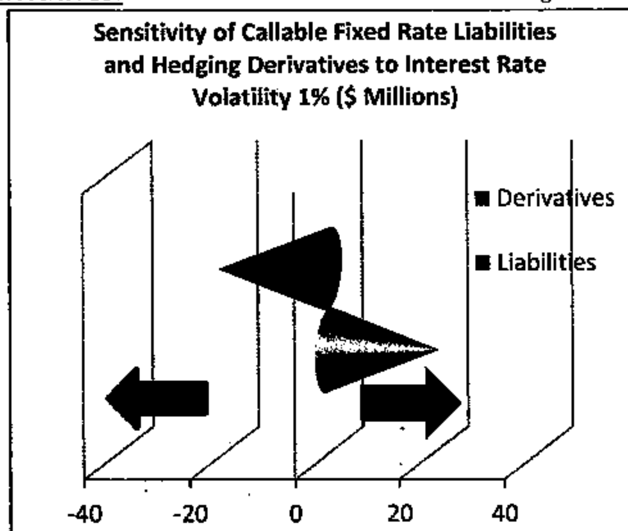
Non-hybrid Liabilities

By eliminating the fair value option on non-hybrid liabilities, the proposed Update accentuates mixed-attribute accounting. For example, where derivatives are used to hedge fixed rate liabilities, the proposed Update requires that the liabilities be carried at amortized cost while the derivatives are measured at fair value. Thus, while the Bank's liability management results in the Bank being appropriately hedged for interest rate risks (see Figure 1) our U.S. GAAP based financial reporting will reflect asymmetric volatility for changes in interest rates. In short, Figure 1 highlights that if rates decline by 100 bps, the Bank will report $4 billion of marked-to-market gains on derivatives hedging non-hybrid liabilities while omitting the marked-to-market losses on the liabilities because the Update will not allow the Bank to recognize that our fixed rate liabilities are effectively hedged with receiver swaps that result in variable LIBOR-based borrowings. The end effect of this significant asymmetry is that U.S. GAAP based results will be irrelevant and misleading for users and the Bank will need to lead users to the fair value presentation in the Management Discussion and Analysis (MD&A).

Hybrid Liabilities and Embedded Derivatives

Clearly and Closely Related Embedded Derivatives:

Figure 2

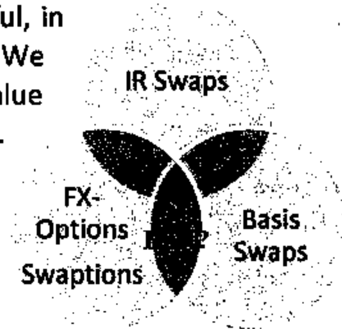


Unlike the FASB's exposure draft *Fair Value Measurements and Disclosures (Topic 820)*, issued in May 2010, the Update scopes-out derivatives addressed under ASC 815-15. This scope-out limits the fair value option to hybrid liabilities with bifurcable embedded derivatives. Since embedded interest rate options are often clearly and closely related to a debt host (e.g., double IRR test), callable bonds will be reported at amortized cost whereas derivatives hedging the bonds will be fair valued. Figure 2 illustrates the effect of this asymmetry relative to Interest Rate (IR) vega for the Bank. In short, changes in interest-rate volatility will impact net income through changes in the value of our hedging derivatives while having no offset from callable bonds (liability) which will be reported at amortized cost. The resulting mismatch in financial reporting for the Bank is potentially in the hundreds of millions (USD).

Not-Clearly and Closely Related Embedded Derivatives:

Bifurcating embedded derivatives from hybrid liabilities is operationally risky and the resulting valuation is often non-meaningful when the embedded derivative is integral to the liability. For example, a Bermudan callable power reverse dual currency (PRDC) liability may be dynamically hedged through interest rate swaps, basis swaps, swaptions

and foreign exchange (FX) options. It would be non-meaningful, in our view, to define a "debt host" and "derivative" for PRDCs. We thus concur with the proposed Update to allow the fair value option for hybrid financial liabilities with bifurcable derivatives. We further believe that financial instruments that meet the bifurcability tests should always be fair-valued to avoid misleading users.



Calling and Repurchasing Own Debt
By not permitting firms to fair value liabilities, U.S. GAAP loses relevance in option exercise decisions because fair value is the basis on which firms call their debt and repurchase their liabilities. Repurchases of debt are often done to help provide liquidity to investors rather than as a "business strategy to subsequently transact at fair value" (ASU825-10-35-10). The proposed Update will not allow firms such as the Bank, which called and repurchased $7 billion of its own debt in the first 7 months of this fiscal year, to fair value liabilities. For repurchases of the Bank's debt, this proposed Update will result in gains or losses triggered by the act of repurchase rather than changes in market conditions. In summary, the proposed Update removes management's ability to appropriately measure financial instruments.

Effects of Own Credit Through OCI
We note and appreciate the FASB's basis of concluding that the effects of own credit should be taken through OCI. We wish to highlight that the effects of own credit for derivative valuation (i.e., DVA) is currently taken-through net income. There would therefore still be an asymmetry in reporting.

Operational Risk
Based on our experience on the ASC 815 embedded derivative rules prior to our adoption of FAS 159, we believe the tests to determine whether a derivative is clearly and closely related are arbitrary and operationally risky. Entities should be permitted to adopt fair value to avoid arbitrary rules that result in non-meaningful measurements.

Possible Way Forward
IFRS 9 currently permits entities to elect the fair value option for financial assets or financial liabilities otherwise measured at amortized cost, to eliminate or significantly reduce an accounting mismatch between assets and liabilities. In addition, the proposed amendments to IFRS 9 would also permit a fair value option for financial assets that would otherwise be measured at fair value through other comprehensive income, if measuring assets at fair value through net income would eliminate or significantly reduce an accounting mismatch. We believe that the FASB should allow the fair value option to be used where not doing so would result in non-meaningful measurement of financial instruments. This would also support convergence efforts with the IASB.

Proposed ASU: Financial Instruments – Recognition and Measurement of Financial Assets and Financial Liabilities

The proposed Update envisages fair value for financial liabilities only where they are issued by broker-dealers in securities or arise from short sales (ASU 825-10-35-10, BC137). In addition, the language of the Fair Value Option in paragraph 825-30-15-2 is not sufficiently clear to understand what "managing the net exposure relating to financial assets and financial liabilities on a fair value basis" entails. There is therefore uncertainty about whether it could be applied in circumstances where, for example, entities are using derivatives to manage the interest rate and currency risks of their funding portfolios, but are not managing their funding and asset portfolios as a matched-book on a fair value basis. We propose that the requirements of this paragraph are either clarified or amended to allow a broader application of the Fair Value Option. We believe that if the firm's business model is one where derivatives are used to hedge financial assets or liabilities, both sets of instruments should be measured on a consistent basis.

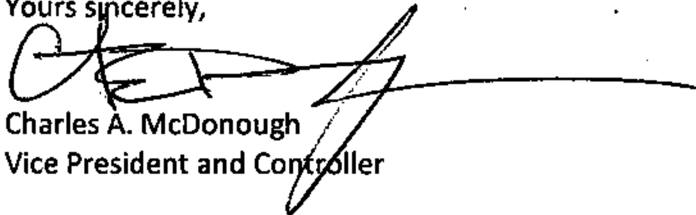
Possible Accounting Model

Since June 2001, the Bank has disclosed fair value results (by reporting all financial instruments at fair value) through its MD&A. The Bank measures and manages market risk indicators on a fair-value basis. We have concerns that the proposed Update is taking a significant step backward in the usefulness of accounting information in measuring performance and risk, and fear that the accounting profession may operate in a paradigm that is detached from real-world decision-making and risk management strategies.

We propose that the FASB develops a model that requires fair value for all financial instruments including derivatives. In our view, as illustrated in our earlier examples, fair value is required to measure and manage market risk for financial instruments.

We appreciate the opportunity to provide you with our views. Please do not hesitate to contact us if you have questions or require clarification.

Yours sincerely,



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Proposed ASU: Financial Instruments – Recognition and Measurement of Financial Assets and Financial Liabilities

Attachment –Answers to Selected Questions

(Only the questions for which answers are being provided are included below)

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments should be included or excluded from the guidance in this proposed Update and why?

We disagree with the scope. By excluding derivatives, the consequence of incomplete measurement and asymmetry is less readily evident.

Recognition

Questions for Users
Question 3: The proposed amendments would require an entity to classify financial assets into the appropriate subsequent measurement category (that is, at amortized cost, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at fair value with all changes in fair value recognized in net income) on the basis of the contractual cash flow characteristics of the instrument and the business model within which financial assets are managed. Does the classification of financial assets based on the cash flow characteristics and the business model assessment provide decision-useful information? If yes, how will this classification influence your analysis of the entity? If not, why?

The classification of financial assets based solely on the cash flow characteristics and the business model assessment does not provide decision useful information. We believe that the proposed amendments will reduce the relevance of U.S. GAAP based financial statements and in some cases, where derivatives are used to manage the risks in those assets, it will create an asymmetry that misleads users such as the Bank in assessing risk. To compensate for this shortfall, we believe that the fair value option needs to be less restrictive to enable entities to properly reflect the risk of financial instruments.

Questions 4: Do the proposed amendments appropriately convey the principle associated with the contractual cash flow characteristics assessment? If not, why? What would you propose instead?

Question 6: Do the proposed amendments contain sufficient application guidance and illustrations on implementing the cash flow characteristics assessment? If not, why?

Question 7: Should a financial asset with a contractual term that modifies the economic relationship (see paragraphs 825-10-55-17 through 55-20) between principal and interest be considered to contain cash flows that are solely payments of principal and interest? Should this be the case if, and only if, the contractual cash flows could or could not be more than insignificantly different from the benchmark cash flows as discussed in paragraph 825-10-55-19? If not, why? What would you propose instead?

Proposed ASU: Financial Instruments – Recognition and Measurement of Financial Assets and Financial Liabilities

Question 8: Do the proposed amendments contain sufficient application guidance in paragraphs 825-10-55-17 through 55-20 on assessing a modified economic relationship? If not, why?

(Answer to questions 4,6-8)

Yes. However, the application of the modified economic relationship as disclosed in the application guidance may result in misleading information. In addition, from a preparer's perspective, the level of effort involved in assessing the materiality of a modified economic relationship could be significant, and may not add much value. There would also be a lot of judgment involved in determining what is significant and this could result in a lack of comparability between the financial statements of various entities.

Question 10: Do the proposed amendments appropriately convey the principle associated with the business model assessment? If not, why? What would you propose instead?

Our concern about the business model concept is that it could enable real business risks to go unreported, rendering accounting information irrelevant. For example, if a bank lends long and funds short, holding both assets and liabilities at amortized cost would not enable the readers of the financial statements to see the effect that a significant change in interest rates (e.g. shorter rates rise more than longer rates) would have on the bank. The bank's financials could look healthy, while the actual situation could be quite dire. As we have noted in past comment letters, we advocate full fair value accounting.

Question 11: Do the proposed amendments provide sufficient application guidance and illustrations on how to distinguish among the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the proposed guidance provided to describe those business models? If not, why?

Yes; however, please note our concerns within our answer to question 10.

Question 12: Should the classification and measurement model for financial instruments contain an explicit tainting notion or should it rely on the principle and exercise of professional judgment? Why?

The classification and measurement model for financial instruments should contain an explicit tainting notion. Without tainting provisions, there is an increased ability to manage income. Since rewards are often tied to financial performance, allowing income management exacerbates the agency challenge of good stewardship.

Question 15: The proposed amendments would eliminate the unconditional fair value option (for financial instruments within the scope of this proposed guidance) in existing U.S. GAAP and, instead, permit an entity to elect to measure at fair value, with all changes in fair value recognized in net income, for all of the following:

a. A group of financial assets and financial liabilities if the entity both:
   1. Manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis
   2. Provides information on that basis to the reporting entity's management.
b. Hybrid financial liabilities that meet certain prescribed criteria.
c. Financial assets that meet the contractual cash flow characteristics criterion and are managed within a business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets (in accordance with paragraph 825-10-25-25(b)).

Do these options provide decision-useful information? If not, why?

We believe that the fair value option as currently written is too restrictive. Entities should be allowed to elect the fair value option in the following circumstances 1) if the entity manages a group of financial liabilities or a group of financial assets and financial liabilities at fair value; 2) to eliminate or significantly reduce an accounting mismatch between financial assets and liabilities, which would otherwise have been measured at amortized cost; 3) to eliminate or significantly reduce an accounting mismatch for financial assets measured at FV-OCI. This would also facilitate convergence with IFRS.

Question 16: Should financial liabilities subsequently be measured at amortized cost, unless certain exceptions are met? If not, why?

We believe the FASB should allow all financial liabilities to be measured at fair value where doing so reflects the risk management strategy of the firm and results in reducing an accounting mismatch. If the firm's business model is one where derivatives are used to hedge financial assets or liabilities both sets of instruments should be measured on a consistent basis.

Question 21: Under the amendments in this proposed Update, hybrid financial assets would not be required to be analyzed for bifurcation under Subtopic 815-15 and would be assessed in their entirety on the basis of the proposed classification requirements. In contrast, hybrid financial liabilities would be assessed for bifurcation and separate accounting under Subtopic 815-15, and the financial liability host contract would be subject to the proposed amendments. Do you agree with this proposal? If not, why? What would you propose instead?

Bifurcating embedded derivatives from hybrid liabilities is operationally risky and the resulting valuation is often non-meaningful when the embedded derivative is integral to the liability. We believe financial instruments that meet the bifurcation requirements under Subtopic 815-15 have significant risk elements that are best measured through fair value.

Question 22: The proposed amendments would require reclassification of financial assets when a change in business model occurs and prescribes how those changes should be

subsequently accounted for. Do you agree with the proposed amendment on reclassifications? If not, why?

No. Entities should have the choice of when the reclassification(s) take place and be required to apply their policy in a consistent manner. Entities should then be required to disclose their policy for making reclassifications.

Question 23: The proposed amendments would require public entities to parenthetically present fair value for items measured at amortized cost on the face of the statement of financial position. Does that presentation requirement provide decision-useful information? If not, why? What would you propose instead?

Yes.

Question 25: The proposed amendments would require an entity to separately present changes in fair value attributable to changes in instrument-specific credit risk in other comprehensive income for financial liabilities for which that entity has elected the fair value option. Would the proposed presentation requirement provide decision-useful information? If not, why? What would you propose instead?

The proposed presentation requirement would not provide decision-useful information because the effects of own credit for derivative valuation (i.e., DVA) would be taken-through NI, while the effect of instrument specific-credit would be shown in OCI. We believe it would be more appropriate to bifurcate the effect of credit (instrument specific and derivative specific) and shown separately through NI.

Question 32: How much time is needed to implement the proposed guidance?

We believe the FASB should allow at least 2 years for implementation