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May 15, 2013

Technical Director, File Reference No. 2013-220 Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

Via Electronic Mail: director@fasb.org, File Reference No. 2013-220.

Re: Proposed Accounting Standards Update, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities

Dear Sir/Madam:

Standard & Poor's Ratings Services appreciates the opportunity to provide the Financial Accounting Standards Board (FASB, or the Board) comments on its Proposed Accounting Standards Update, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (the Proposed Update).

The views expressed in this letter represent those of Standard & Poor's Ratings Services and do not address, nor do we intend them to address, the views of any other affiliate or division of Standard & Poor's Financial Services, LLC. We intend our comments to address the analytical needs and expectations of our credit analysts. <sup>1</sup>

#### Overview

Standard & Poor's Ratings Services greatly supports the FASB's objective to provide financial statement users with more decision-useful information about a company's financial instruments, while concurrently simplifying the accounting for those instruments. We believe the accounting treatment of financial instruments should reflect the fundamental business and economic purpose for transacting those instruments, and provide useful information on the amounts likely to be realized or paid. The optimal depiction of financial instruments (i.e., whether they are presented at amortized cost or fair value on the statement of financial position) should consider a company's asset-liability management model and its business strategy, in our view. In some cases, fair value accounting would best achieve those objectives; in other cases, amortized cost treatment may provide a better representation.

We believe this Proposed Update, expected to create a single, comprehensive standard for measuring financial instruments such as loans, securities, hybrids, and deposits within its scope, to be a significant step forward in simplifying and improving the quality of financial reporting. The Proposed Update largely places emphasis on how a company manages its myriad of financial

<sup>&</sup>lt;sup>1</sup> The opinions stated herein are intended to represent Standard & Poor's Ratings Services' views. Our current ratings criteria are not affected by our comments on the Proposed Update.

instruments to help determine its appropriate accounting treatment. By allowing for a mixed-attribute model for most financial instruments, we expect the Proposed Update to lead to financial reporting that better reflects how the underlying cash flows of those financial instruments will be realized or paid. Financial-report users have diverse information needs, and use different financial metrics to assess a company's performance and financial position. We therefore strongly favor the Proposed Update's call for a more prominent, consistent display of fair value information within financial statements when amortized cost has been determined to be the more appropriate accounting basis; however, this approach should be required for public and private companies, because we do not differentiate between the two from a credit analysis perspective.

We are pleased that in many respects, the current Proposed Update is more aligned with our previously submitted comments to the FASB's exposure draft, "Accounting For Financial Instruments And Revisions To The Accounting For Derivative Instruments And Hedging Activities" issued in May 2010 (See Standard & Poor's Ratings Services Comment Letter Response #1858). For example, we recommended--and the current proposal reflects--a three-category approach for the classification and measurement of most financial assets which includes fair value with changes recognized through net income (FV-NI), fair value with changes recognized through Other Comprehensive Income (FV-OCI), and amortized cost (AC). We also previously supported--and believe the current proposal largely reflects--the recognition of financial liabilities such as long-term debt at amortized cost, in most cases.

Still, we have some concerns about this Proposed Update, and believe further improvements should be made before it is issued. Specifically, we do not agree that all equity securities (other than those specifically excluded through a fair value practicability exception) should be recorded at fair value with changes reflected in earnings. Considering this standard will affect companies across various sectors, such a requirement may not reflect certain companies' business need for holding these types of instruments. For example, life insurance companies hold equity securities in their long-term investment portfolios, rather than for the purpose of meeting day-to-day claim payments. We believe this approach may go against the overall objective and spirit of the Proposed Update, and introduce undue volatility--that is, volatility that may not represent the underlying economic activity being conducted--in the income statement that could affect the computation and results of earnings margins used in our analysis.

We further believe more steps toward global consistency and convergence should be considered. Although the FASB and the International Accounting Standards Board (IASB) in their latest proposals converged on creating a three-category model for the classification and measurement of financial assets, differences in the guidance related to the FASB and IASB's proposed business model assessments remain. For example, unlike the IASB's recent proposal, we believe the Proposed Update provides robust guidance around the types of potential financial instrument sales that could prohibit amortized cost treatment under U.S. GAAP, which could in turn lead to different financial instrument classification between International Financial Reporting Standards (IFRS) and U.S. GAAP once final accounting guidance is issued by both Boards. Moreover, the potential difference in accounting for equity securities could cause markedly different financial statements under the two major accounting regimes. The IASB's proposal allows a company to change the accounting measurement of companies' equity securities from FV-NI (as noted, the FASB requires) to FV-OCI by way of an irrevocable election at the time the equity instruments are initially recorded on the balance sheet. We understand, no such election opportunity exists in this Proposed Update.

Because we rate companies globally, the comparability of accounting and financial reporting guidance is important to our peer analysis. Experience during the most recent financial crisis highlighted differences in accounting guidance and practices among various companies and financial institutions in particular. We therefore believe the FASB and IASB should work together to eliminate the remaining meaningful differences between the two proposals, in order to truly create a single converged standard for financial instruments. Without further convergence, financial statements of U.S. companies reporting under U.S. GAAP and companies reporting under IFRS may not be comparable.

Our views are further outlined below.

### Financial Assets - Classification, Measurement, And Disclosure

# We support dual consideration of cash flows and a companies' business model in determining the classification and measurement of a financial asset

We generally support the consideration of a financial asset's cash-flow characteristics and a company's business model in which the asset is managed to determine its classification and measurement. We believe this approach most appropriately reflects the practical considerations contemplated in how a company expects to realize the cash flows embedded in those financial assets. In our view (and as proposed):

- Instruments held for the collection of contractual cash flows should be recorded at amortized cost. Amortized cost instruments should be accompanied by parenthetical fair value disclosure directly on the face of the balance sheet.
- Instruments held for contractual cash flows or for later sale (i.e., where no determination has been made at recognition) should be recorded at fair value with changes reflected through other comprehensive income.
- Instruments that do not fit either of the above categories and are effectively managed on a fair-value basis should be recorded at fair value, with changes reflected through net income.

The Proposed Update requires that a cash flow characteristic test be performed prior to the company considering its business model for holding those securities. The intent is to ensure that only instruments that give rise to contractual cash flows composed solely of payments of principal and interest be considered for AC or FV-OCI accounting. All other financial assets will be accounted for at FV-NI. The IASB's proposal contains similar dual consideration although the order of consideration is reversed. We believe the FASB and IASB proposals will likely result in financial instruments such as trade receivables, loans held for investment purposes, and plain-vanilla type debt securities achieving AC or FV-OCI accounting treatment, which we believe is appropriate.

# We believe the underlying business model is relevant to the accounting and reporting of equity securities

Under the Proposed Update's dual consideration, all equity securities (other than equity investments and securities excluded by the Board because of the lack of readily determinable fair values) will be accounted for at FV-NI, because equity securities do not consist of contractual cash flows composed solely of principal and interest. We do not agree with this outcome. We recognize that equity securities, by definition, do not consist of contractual cash flows composed solely of principal and interest. However, we believe consideration of a company's business model should be afforded to equity securities so that changes in fair value can be reported outside of earnings. If equity securities

(e.g., common shares of another publicly traded company) are held to generate cash flows through frequent sale activity (as in the case of a trading portfolio), we believe it's appropriate for companies to report fair-value changes through earnings. If, however, a company does not manage its equity securities consistent with a trading portfolio (often the case in certain industries or because of certain strategies), it should be able to report fair-value changes of its equity securities portfolio through OCI (to the extent the securities are not subject to impairment).

We believe the ability to change the geography of fair-value changes could be accomplished either by an irrevocable election (similar to the IASB's proposal) or potentially through a specific exclusion of equity securities from the proposed dual assessment. Nevertheless, a blanket requirement to record all fair-value changes through net income may not best represent a company's business purpose for holding these types of securities in some cases.

# Relevant disclosure of cash flow characteristic analysis and business model considerations would help improve consistency

Because we believe determining whether cash flows are solely payments of principal and interest may be complex and lead to incomparable outcomes for certain instruments (e.g., certain bonds or structured securities within an investment portfolio), we recommend that relevant disclosure of key assumptions and judgment used by management be provided. These disclosures should be clear and concise, but reflect the decision-making process of management based on the type and characteristic of an instrument within a portfolio. This will help users understand any possible differences in application of the cash flow characteristics test. Over time and with appropriate disclosure, we would expect differences to narrow and comparability to be improved.

We also support robust qualitative disclosure of the factors companies considered in determining a company's business model. There is sometimes a thin line between financial instruments that might be categorized as FV-OCI or FV-NI. Financial instruments within these categories could be held for a variety of reasons, including for economic hedging purposes, for strategic purposes or for opportunistic trading such as potentially offsetting operating losses elsewhere with gains on securities. We believe disclosure could help users better understand how management distinguishes its business models to arrive at their reported classification, and better discern any differences in approach across companies or over time.

# Fair-value disclosures of amortized cost balances should be of the same rigor and disaggregation as if fair value was the accounting basis

We believe fair-value disclosures of amortized cost balances (even though disclosed parenthetically under the Proposed Update) should be of the same rigor and disaggregation as if fair value were the accounting basis. We recognize that under current accounting, fair-value information about loans and other financial instruments accounted for at amortized cost on the balance sheet generally is not consistent with an "exit price" notion that exists in fair value measurement guidance. In the absence of specific guidance for fair value disclosures, we find that companies often use different methods to estimate fair values, such as using a simple "entry price". Therefore, we support the Proposed Update's efforts to improve the consistency of fair-value information. In our analysis, amortized cost and fair value information are useful and important. Fair-value disclosures of instruments

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<sup>&</sup>lt;sup>2</sup> See "Investment Portfolios Have Become A Key Profit Generator for U.S. Large, Complex Banks" published July 24, 2012 on the Global Credit Portal - RatingsDirect (www.globalcreditportal.com).

accounted for at amortized cost aid our analysis and assessment of a company's liquidity and other key financial measures. For example, in extreme markets with the potential for forced liquidation or unplanned sales, amortized cost balances in isolation may not be sufficient for analysis. We believe this is the case for public and nonpublic companies.

We also recognize the Board has been separately working to improve liquidity disclosures that we often find deficient in informing users about the risks and uncertainties a company faces in managing its liquidity needs. Analyzing liquidity sources and potential liquidity constraints is an important component of issuers' viability and our analytical process. Despite the fair-value disclosures in the context of this Proposed Update, we believe the Board should continue its efforts to improve liquidity disclosures more broadly.<sup>3</sup>

### We support infrequent reclassification of financial assets

We agree with the Proposed Update that reclassification of financial assets between categories should be infrequent and permissible only upon a change in business model. We believe this will allow financial statements to better reflect the economics of a company's strategy and activities which, on rare occasions, may need to be rebalanced. To the extent reclassifications occur, we believe the disclosures required in the Proposed Update will help provide users with an understanding of the reason for the change.

#### Financial Liabilities - Measurement And Disclosure

#### We support measuring financial liabilities such as debt at amortized cost, in most cases

We generally support measuring nonderivative financial liabilities, such as debt, at amortized cost. We agree with the Proposed Update that if a company's business strategy at the incurrence of a liability is to subsequently transact at fair value or the liability results from a short sale, then fair value is a more appropriate measure. We have long held that amortized cost is the most relevant way for companies to account for long-term debt (and core deposit liabilities) in the financial statements. We believe it best reflects the amount ultimately required to be paid or settled on the liability under a going-concern concept. Certain liabilities--such as long-term debt, in particular--are seldom settled at theoretical market prices.

The Proposed Update would require a public (but not private) company to present parenthetically, on the face of the balance sheet, the fair value of financial liabilities that are measured at amortized cost. We support this disclosure but believe it should also be extended to private companies. Fairvalue information of a financial liability recorded at amortized cost, in our view, provides valuable insight on potential changes in a company's cost of funding. It also provides insight about a company's business and financial prospects. For example, as the fair value of debt declines because of factors related to worsening market conditions, assets (or equity) that could be used to absorb the decline in financial liabilities likely also will deteriorate. Therefore, we believe parenthetical fair value disclosure of long-term debt obligations prominently displayed on the face of the balance sheet is most ideal for both public and private companies. As stated earlier, related to financial assets, we believe fair-value disclosures of amortized cost balances should be of the same rigor and disaggregation as if fair value were the accounting basis.

<sup>3</sup> See "How Enhanced Funding And Liquidity Disclosure Could Improve Confidence In the World's Banks" published June 18, 2012 on the Global Credit Portal – RatingsDirect (www.globalcreditportal.com).

#### We favor restricting the use of the fair-value option to mitigate reporting mismatches

We understand the Proposed Update significantly limits a company's use of the fair-value option (FVO) to groups of financial assets and financial liabilities for which the company manages the net exposure on a fair-value basis; hybrid financial liabilities; or financial assets that qualify for the FV-OCI business model. If applied, the measurement basis of these assets and liabilities would be fair value, and all changes in fair value would be recognized in net income.

We have long favored elections for fair-value measurement of financial liabilities (and assets) that are based on a desire to mitigate a financial statement mismatch and therefore better represent the underlying economics of asset-liability management. We support eliminating unconditional use of a FVO and believe a restriction on its use would improve financial reporting.

We understand, however, that based on the current proposals, differences between the FASB and IASB's allowed use of the FVO would remain. For example, in addition to allowing a company to apply a FVO on groups of financial assets and liabilities which are managed on a net basis, IFRS 9, *Financial Instruments*, allows a company to elect a FVO for assets and liabilities otherwise measured at amortized cost if it eliminates or significantly reduces an accounting mismatch between those assets and liabilities. We do not oppose such expansion if it is appropriately limited and disclosed. However, we are concerned that differences could affect users' analysis of global peers, and we believe the Boards should substantially converge on this important aspect.

# Removing the effects of changes in own-credit standing from earnings is a partial improvement

The Proposed Update would require a company to recognize changes in own-credit standing in OCI rather than in earnings for those financial liabilities that are designated under the fair-value option. We believe this is a slight improvement in financial reporting; however, it is less than ideal. The proposed change would continue to reflect own-credit adjustments in capital measures and will not result in accounting that better reflects the underlying settlement of most long-term debt obligations, in our view. For most--if not all--solvent issuers, financial liabilities such as debt are settled at par, even if creditworthiness varies (e.g., an 'AAA' and a 'BBB' rated company that both face an imminent maturity will pay the same amount at maturity, regardless of the differences in their perceived credit quality). We therefore favor measuring long-term debt obligations at amortized cost, with disclosure of fair-value information.

Moreover, own-credit adjustments, by definition, affect fair-value measurements of financial liabilities more broadly, not just those designated under the fair value option. Therefore, we believe it is important that companies provide appropriate disclosures of own-credit adjustments, whether or not the fair-value option is applied. For example, own-credit adjustments often have a sizable effect on the balance of a company's derivative liabilities. In our analysis, we attempt to remove the cumulative effect of own-credit adjustments from our capital measures (and the period effects from earnings). Yet, we often find that information about own-credit adjustments is unclear and inconsistent. Therefore, we believe comparable required disclosure of own-credit adjustments for financial liabilities will improve the transparency of financial reporting.<sup>4</sup>

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<sup>&</sup>lt;sup>4</sup> See "Criteria | Financial Institutions | Bank Capital Methodology And Assumptions", published December 6, 2010 on the Global Credit Portal – RatingsDirect (www.globalcreditportal.com)

## Certain disclosures of core deposit liabilities would help

Core deposits are a key part of our bank funding analysis.<sup>5</sup> Yet, we often find that disclosure of what a bank considers to be core deposits and stable sources of funds is lacking. Despite the definition of core deposit liabilities provided in the Proposed Update, we believe banks and financial statement users may differ in their views about what is or is not a core deposit. We often use financial information provided in regulatory filings and other publicly available sources to assess a bank's stable sources of funds. In our analysis of liquidity, we may calculate a bank's core deposits by subtracting from total reported deposits the amount we believe is more likely to run-off in a stress scenario. These deductions may include interbank deposits, time deposits with short remaining maturities, and excess deposits greater than FDIC-insured amounts. Moreover, we also consider commercial deposits, to the extent the information is available, because we believe these types of deposits are likely to run off more quickly in a stress scenario than retail deposits. We believe a requirement to provide a breakdown of the type of deposit and a qualitative description as to what a company includes as a core deposit would be helpful to users.

We support the proposed disclosures of the core deposit liability balance. We also support the related disclosure of the implied weighted-average maturity period, because it provides insight into the stability of those core deposits and improves peer comparisons. However, we find disclosure of the proposed estimated "all-in-cost-to-service rate" to be less pertinent and relevant to our analysis.

#### **Other Considerations**

## Expanded use of OCI may require closer examination

We encourage the Board to work with the IASB to determine what should be included in OCI and why (i.e., defining its use within the accounting framework) and whether and when amounts should be recycled from OCI to earnings. We recognize the Boards have aligned the presentation of OCI; however, the expanded use of OCI may require closer examination. For example, we understand there are current differences between the Boards' approaches to recycling of items initially reported in OCI, whereby the IASB proposal would disallow certain amounts to be subsequently recognized in profit or loss even when realized (e.g., fair-value changes of equity investments). Our view is that any remaining gains and losses in OCI upon realization or disposition of a financial instrument should be included in net income in that period. We believe the FASB should work with the IASB in developing a converged solution in this important area.

#### Disclosure framework: international consistency and convergence should be considered

We encourage the FASB to develop a disclosure framework jointly with the IASB. Disclosures are a key facet in analyzing a range of information related to financial instruments. Beyond the classification and measurement basis, relevant disclosures such as the sensitivities around fair value measures, credit and counterparty concentration, asset-liability management practices, valuation and other assumptions, liquidity risk and considerations, and significant changes in these and potentially other factors provide extremely useful information to financial statement users. Therefore, we reiterate to the Board the importance of a comprehensive disclosure framework developed jointly by the FASB and IASB that could make significant strides in improving the financial reporting of

<sup>&</sup>lt;sup>5</sup> See "Criteria | Financial Institutions | Banks:Rating Methodology And Assumptions", published November 9, 2011 on the Global Credit Portal – RatingsDirect (www.globalcreditportal.com).

financial instruments overall (see Standard & Poor's Ratings Services Comment Letter Response #46 to the Disclosure Framework Discussion Paper).

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We thank you for the opportunity to provide our comments, and we would be pleased to discuss our views with members of the FASB or your staff. If you have any questions or require additional information, please contact the undersigned.

Very truly yours,

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