August 31, 2010

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116
United States of America

Re: File Reference No. 1810-100; Exposure Draft of a Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

Dear Mr. Golden:

Citigroup appreciates the opportunity to comment on the Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the Exposure Draft or the ED). We share the Board's concerns about providing financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments, while reducing complexity in accounting for those instruments. We also support the FASB's efforts to achieve greater convergence with the IASB. However, we do not support the issuance of the ED as currently drafted, because it would increase rather than reduce complexity, and it would create greater divergence rather than convergence with International Financial Reporting Standards (IFRS). Significant improvements are needed before the proposed ED can be issued as final guidance. Our most significant concerns are that:

- the ED's proposed classification and measurement proposals do not appropriately reflect how businesses utilize financial instruments to generate earnings for the entity's debt and equity holders;
- there are very significant operational issues in both the classification and measurement and impairment proposals that do not seem justified by any desired transparency in financial reporting;
- the proposed impairment model along with the interest recognition provisions will sow confusion, rather than clarity, among financial statement users through the commingling of credit impairment and interest income;
- the proposal's greatly increased use of fair value would result in a dramatic expansion of Level 3 financial instruments for assets and liabilities that do not have a readily determinable market value;
- the core deposit remeasurement model is conceptually flawed; and
- the ED's non-accrual provisions will create significant differences in non-accrual reporting under U.S. regulatory guidelines versus generally accepted accounting principles (GAAP).

Business Model
The FASB should establish a better conceptual framework of the business model applicable to financial instruments. We strongly believe that financial instruments should be subject to a mixed attribute accounting model (fair value through earnings and amortized cost); therefore, we object to the fair-value-for-almost-all-financial-instruments approach proposed by the FASB as conceptually flawed.

The value of an asset comes from how it will be used to generate earnings for debt and equity holders. The two ways to generate value from any asset, whether plant and equipment or a financial instrument, are either to sell it or generate a return over its useful life.

Instead of requiring fair value for all financial instruments, the FASB should establish criteria for when sales value (i.e., fair value through net income) or return over useful life (i.e., amortized cost) should be used to reflect the value of an asset in financial statements. There are two criteria for when sales value (fair value measurement) should be used for valuation:

- The firm is not a going concern; **or**
- The firm intends to sell the asset in the course of business or may reasonably be forced to sell the asset given business circumstances.

Similarly, there are two criteria for when return over useful life should be used for valuation:

- The firm is a going concern; **and**
- The firm intends to hold the asset to realize value during the asset's useful life and has the ability to hold the asset during that time period.

Since a vast majority of financial institutions are going concerns, the real issue is whether the entity has the intent to realize value through holding the asset over its life, and whether the entity also has an ability to hold the asset over the intended value realization period. In addition to intent, which is relatively easy to judge based on history and management's declared intent, one must assess an entity’s ability to hold an asset through adverse periods. If an entity may be forced to sell an asset during an adverse period, then its sales value determines the realizable value.

Through the utilization of fair value and amortized cost, the mixed attribute accounting model allows the measurement and reporting of financial instruments to reflect the way these instruments are actually managed. That is, a better representation of the business’ purpose for holding non-trading financial instruments would be achieved through the continued use of the amortized cost accounting model. While fair value through net income is an appropriate accounting model for trading businesses that follow the “realize through sale” model, fair value either through net income or other comprehensive income (OCI) does not best reflect the activities of a business that is managed for cash flow and liquidity management purposes to realize the value through holding a majority of its assets over their useful lives. For such non-trading businesses, fair value does not help a financial statement user project the business’ cash flows, revenues or expenses. As a result, the financial statements would provide a less transparent view of the entity’s business operations and its performance.

Since assets held to realize long-term value must be supported with long-term funding (long-term debt, core deposits, etc.), the liabilities funding the assets should be measured consistently at amortized cost. Please see the *Business model approach* section in Attachment I for additional comments.

For these reasons, the IASB's mixed attribute classification and measurement model for financial instruments in IFRS 9, *Financial Instruments*, the Exposure Draft, *Fair Value Option for Financial Liabilities,* and IAS 39, *Financial Instruments: Recognition and Measurement*, while not perfect, is superior to the FASB's proposed classification and measurement model. There are some aspects of the IASB's classification and measurement model that we do not support; specifically, these aspects relate to not allowing recognition of unrealized gains and losses in net income when they are realized (that is, no "recycling"). We also disagree with IASB's proposal for the differing treatment of hybrid assets and hybrid liabilities.

Operational Issues

The ED would require development and maintenance of multiple financial reporting and risk systems to support the fair value information required for the primary financial statements. For financial assets carried at fair value through OCI, both amortized cost information and fair value information would be needed for the balance sheet along with the accumulated impairment. The vast majority of the financial instruments not reported at fair value today are not publicly traded and many of the significant inputs used in fair valuing them for disclosure purposes are not observable. Furthermore, the process for estimating fair value for these instruments is complex and time consuming. While the fair value of those instruments is currently calculated on a quarterly basis for disclosure purposes, if they were to be reported at fair value in the primary financial statements, their fair value would have to be estimated at least monthly for management reporting and analysis purposes. This would create a significantly increased operational burden. The Board noted in paragraph BC58 of the ED that "the Board believes that fair value information would now likely be available at the time of earnings releases rather than only being disclosed later in the notes to the financial statements for public entities." We note that due to the complexity of the valuation models and the longer time needed to estimate unobservable inputs, requiring recognition of fair values for these instruments in the primary financial statements could lead to significant delays in earnings releases, especially for financial institutions.

New financial and risk systems would also need to be developed to support the ED's credit impairment and interest recognition proposals. The FASB's credit impairment model is impracticable, as it mixes interest income and the allowance for credit losses together and is far more complex than the existing loan loss reserve models. Currently, credit and interest rate risks are managed separately, and different financial and risk systems are used to gather the requisite information and monitor those risks. Under the ED, multiple models would be required for the fair value and credit impairment information relating to financial assets carried at fair value through OCI (as further described under "Credit Impairment Model" below). For these assets, expected losses will need to be calculated and updated quarterly using two different sets of assumptions, i.e., one that forecasts future events (for fair value measurement) and one that does not (for credit impairment).

In addition, major systems revisions and/or new systems would be needed to comply with the ED's interest income recognition proposals without a corresponding benefit to the users of

financial statements. Extensive records would have to be maintained for each asset carried at fair value through OCI to:

- calculate and record the original effective interest rate and periodic updates thereof, as required;
- estimate changes in expected future cash flows;
- calculate the amount of accrued interest based on amortized cost net of the loan loss reserve;
- calculate the amount of interest contractually due (or expected to be collected for purchased impaired loans) that exceeds the amount of interest accrued and that must be added to the loan loss reserve; and
- calculate the amount of loan loss reserve that exceeds the cash flows not expected to be collected which would require a reduction of the allowance and the provision for loan losses.

We anticipate that methods of measuring own-credit valuation adjustments (CVA) for financial liabilities would need to be developed, greatly expanding the current limited measurement of CVA for liabilities for which the fair value option (FVO) has been elected and reflecting the ED's revised definition of an entity's specific credit risk component. Moreover, the ED greatly increases the complexity and cost of achieving hedge accounting for dynamic hedging strategies as a result of the proposed disallowance of dedesignation and redesignation of a hedging instrument. Furthermore, the remeasurement of core deposits, as further described under "Core Deposits" below, will create many operational challenges.

The development of all these new systems and valuation models would require an enormous investment and significant amounts of time and resources to implement across the financial services industry without significant benefit for the users of financial statements.

Foreign currency transaction gains/losses on items measured at fair value through OCI
We strongly object to the proposal in the ED that foreign currency transaction gains/losses on items accounted for at fair value through OCI should be recorded in OCI. This is currently a significant difference between U.S. GAAP and IFRS, and we see no reason why the proposals in the ED represent an improvement in financial reporting. We believe that U.S. GAAP and IFRS could be converged in this area, and U.S. GAAP could be significantly simplified and improved by requiring that **all** foreign currency transaction gains and losses be recorded in earnings immediately. Please see additional comments on this issue in the *Subsequent Measurement* section in Attachment I.

Credit Impairment Model
We disagree with the FASB's overall credit impairment model. It would be inappropriate to immediately recognize lifetime credit impairment at origination of a loan or debt security not held in a trading portfolio. The revenue associated with these financial assets is recognized over their lives and the related costs (e.g., credit impairment) should follow a similar pattern. Upfront recognition of all expected losses, without consideration of the future earnings that are intended to support/absorb these costs, is illogical.

While we disagree with the linking of interest income and credit impairment, we concur with the IASB's proposal (in the Exposure Draft, *Financial Instruments: Amortised Cost and Impairment*) to allocate a portion of expected credit losses over the life of a financial asset, although the allocation would need to be augmented by immediate recognition of incurred losses. Moreover, the IASB's loss recognition methodology at origination is conceptually inconsistent with their proposal that subsequent changes in the estimated credit losses should be recognized immediately through a catch-up adjustment.

The Expert Advisory Panel's (EAP) proposals should be seriously considered. This approach is based upon expected loss rather than expected cash flows – thereby decoupling credit losses from interest income – and segregates a loan portfolio into a good book and a bad book (which includes all impaired assets). Reserves for the bad book would be equal to lifetime expected losses (as determined in accordance with ASC 310-10-35 (formerly FAS 114)), while reserves for the good book would be established through periodic recognition of expected losses over the portfolio's remaining life, augmented by immediate recognition of incurred losses. The FASB and IASB should work together on a single credit impairment model that will reduce the number of competing models without distinction between assets that are originated and those that are purchased.

The ED does not specify whether or not loss reserves for assets evaluated for credit impairment as part of a pool should be discounted. Such loss reserves should be discounted, with the discount subsequently reflected as credit adjustment to the provision for loan losses, to reflect the time value of money and to be consistent with the methodologies for individually evaluated originated assets and purchased assets. Also, with the changes to the overall impairment model, a separate credit impairment model for purchased assets is no longer justified. Rather, there should be one model for individually evaluated assets and one for assets evaluated for impairment as part of a pool of similar assets, covering both purchased and originated assets.

In addition, the ED's proposed impairment model would be pro-cyclical as it would require entities to book significant credit reserves at the bottom of the economic cycle without allowing them to assume that conditions would ever improve; this would result in overestimation of the expected credit losses. The opposite would happen at the top of the economic cycle when entities would have to record only minimal credit reserves, because their model inputs are not allowed to assume that the economy would deteriorate in the future. This result is counterintuitive and unrealistic.

The proposed guidance would require that an entity assume that the economic conditions existing at the end of the reporting period would stay unchanged for the remaining life of the financial assets and would not forecast future events or economic conditions that did not exist at the reporting date. An expected loss approach that includes consideration of future events would be more appropriate and is, in fact, required to determine a financial asset's fair value. It is unrealistic to assume that economic conditions existing at the end of a reporting period would remain unchanged for the remaining life of a financial asset. Accordingly, this aspect of the IASB's proposal, which allows the forecasting of future events and conditions, is more appropriate, although we oppose the IASB's proposal to use a probability-weighted method to calculate the amount of the expected credit losses, since there would be a significant operational burden placed on any institution with a sizeable financial instrument portfolio.

The ED will require two cash flow analyses – one for credit impairment purposes that assumes no change in current economic conditions and a second one to establish the asset's fair value, which will have to incorporate assumptions on future events. As a result, the valuation methodologies for the financial asset and its related credit impairment reserve are inconsistent – the asset is at fair value, but the loan loss reserve (by virtue of excluding expectations of future events) is not. This will cause net income and accumulated OCI impacts that will be illogical, depending on where one is in the economic cycle (e.g., if economic conditions are expected to deteriorate, OCI will reflect the higher expected losses and net income will not).

In addition, the ED's requirement that only historical information and existing conditions may be used to develop estimates of life of loan losses is unworkable and will produce estimated "losses" that do not measure the entity's actual expectations of future losses. Financial statement users will disregard such estimated losses, because they are not based on the best information available and are not economically supportable. Accordingly, expectations of future economic trends and conditions should be factored into the impairment calculations. However, if the FASB pursues its current proposed methodology, further clarity on "an entity's expectations about collectibility" would be helpful. For example, if the unemployment rate has dropped for the past two quarters and current economic data as of the balance sheet date indicate that the rate will continue along this trend, is it acceptable to forecast a future unemployment rate decrease, especially if history shows that these other factors are early indicators of unemployment improvement?

Interest Income Recognition Model

Interest income should not be affected by the recognition or reversal of credit impairments. Interest income recognition should be based on the financial asset's effective interest rate (EIR) applied to the amortized cost balance, rather than amortized cost net of any allowance for credit losses, as this provides a more accurate portrayal of the economic yield associated with the asset and is not an area of current GAAP that has been subject to debate or abuse. Conceptually speaking, one could view credit impairment as one of the costs necessary to generate interest revenue. Separate presentation of revenue and the related expenses incurred provides important financial relationship details; commingling interest income and credit costs could obfuscate these details, particularly for a financial institution. Financial statement users are unlikely to find this mixed presentation of credit losses and interest income useful in analyzing a reporting entity's results of operations.

In today's financial statements, interest income is a measurable, relevant disclosure based upon specific cash flows, and the net interest margin is a key statistic monitored by bank analysts. Under the ED's proposal, the reliability of these disclosures would be greatly diminished, since they would no longer be measured by contractual terms and actual cash receipts, but rather, based upon estimated balances subject to quarterly changes in impairment estimates. Therefore, the accounting for the allowance for credit losses should not be commingled with the accounting for interest income, as such commingling would decrease transparency and confuse financial statement users that have a clear understanding of credit losses and interest income under existing GAAP.

Furthermore, this approach would require frequent increases in the allowance for credit losses due to contractual interest exceeding recorded interest income, which would then be released against the provision for loan losses. This would effectively result in a reclassification of

interest income to the provision for loan losses that would be extremely difficult to achieve operationally, and which would be detrimental to the users of the financial statements. Also, effective interest rates are generally calculated on an individual asset basis, while credit loss expectations are often derived on a pool basis. It is inappropriate to treat pool-driven estimates as an adjustment to an individual loan's EIR.

Finally, the same interest income recognition model should apply to all financial instruments, regardless of whether the instruments are evaluated for impairment on an individual or pool basis, are purchased or originated, or are reported at fair value through net income or OCI.

Core Deposits
The core deposit remeasurement model is conceptually flawed. As discussed in more detail in our following comments, the ED would incorporate elements of a core deposit intangible asset into the valuation of a financial instrument, in particular, a financial liability. The ED proposes to record a core deposit liability measurement at a period-end using an average balance for the period to determine the reported balance. This is inconsistent with the principle that a balance sheet reflects positions at a point in time – the end of the reporting period. Furthermore, the remeasurement methodology proposed is highly complex and would require a great deal of subjectivity in determining the average lives of the core deposits, the all-in-cost-to-service rate and the alternative funds rate. As a result, there would be inconsistencies in the assumptions made by each reporting entity, thereby decreasing comparability of the resulting remeasured amounts.

Additionally, in the case where the core deposit was acquired through a purchase and not internally developed, the balance sheet would be double counting the core deposit intangible – once as an asset and a second time as a component of the core deposit liability. The FASB should reconsider whether it is appropriate to recognize internally developed intangible assets in a separate project, as the recognition of one internally developed intangible asset should not be within the scope of this financial instruments project.

Core deposit liabilities should be measured at amortized cost. However, if the FASB decides to require other financial assets and liabilities to be measured at fair value, it would be inconsistent to treat core deposit liabilities differently.

Expansion of Fair Value
The proposal's greatly increased use of fair value would result in a dramatic expansion of Level 3 financial instruments for assets and liabilities that do not have a readily determinable fair value, particularly those that are not currently carried at fair value. As most of the instruments that would be newly required to be reported at fair value under the ED, such as consumer loans, are seldom, if ever, traded and many instruments are carried in businesses/regions with virtually no secondary market, the only alternative for developing a fair value estimate is expanding the use of financial models whose inputs would largely be unobservable.

As was apparent during the financial crisis, financial statement analysts and the financial press expressed significant skepticism about the validity of fair values developed using models. In addition, credit valuation adjustments (CVA) recorded on an entity's own debt produce counterintuitive results in the income statement – that is, an entity reports higher income (or equity) when its credit spread deteriorates and reports lower income (or equity) when its credit

spread improves. The existing required CVA adjustments for derivatives and FVO liabilities have resulted in significant volatility in earnings and have been uniformly disregarded by financial institution analysts, who consider it to be meaningless and consistently adjust reported earnings to remove the effects of CVA adjustments. In addition, when Citigroup discusses its results with the market, we discuss them without the impact of CVA in a discussion of "normalized" earnings.

Hedging
While some improvements are needed, we generally support the ED's provisions relating to hedge accounting, including hedge designation by type of risk, requiring hedges to be reasonably effective rather than highly effective, and a qualitative effectiveness assessment instead of the current quantitative assessment. These changes will serve to reduce complexity in this currently very complex area. However, we fail to understand why voluntary hedge dedesignations without terminating the hedging instrument should not be allowed. Dedesignation and redesignation of hedge relationships reflects the dynamic nature of hedging as a prudent risk management practice. Prohibiting dedesignation only limits management's ability to manage risks through changing economic environments and balance sheet composition. Further, the prohibition of hedge dedesignation also increases complexity and cost to the reporting entity, since the same reporting result would be achievable by terminating the hedging instrument.

Equity Method Accounting
We object to the requirement that the equity method only be permitted when the operations of the investee are related to the entity's consolidated business. We believe the criteria for using the equity method are inconsistent with the Board's consolidation model for variable interest entities (VIE) and controlled non-VIEs, where there is no requirement that a VIE's or controlled non-VIE's operations be related to the parent's consolidated operations.

Non-accrual Assets
We are concerned about the non-accrual provisions of the Exposure Draft. The ED would create a regulatory reporting (RAP) to GAAP difference and would be difficult to implement operationally, as dual interest income reporting systems would be needed. Furthermore, for U.S. banks, it would significantly decrease the number of assets that would be classified as non-accrual under GAAP, relative to the amounts that are currently reported. This would decrease the transparency of financial institutions' financial statements and possibly eliminate certain important and widely used credit metrics for analysts (i.e., non-performing loan statistics).

Lack of Convergence
Finally, the proposed ED fails to achieve convergence on fundamental issues in a critical area of GAAP. Without convergence, financial statements of U.S. companies reporting under U.S. GAAP and foreign companies reporting under IFRS would not be comparable. Moreover, failure to achieve convergence in this area would have a very detrimental impact on financial institutions and other global companies with subsidiaries that apply IFRS for local reporting. Additionally, as the SEC is finalizing the timetable for the eventual adoption of IFRS for U.S. registrants, we are very concerned that U.S. GAAP registrants will be required to implement significant changes in U.S. accounting standards for financial instruments that are not convergent with IFRS and shortly thereafter be required to undertake a second significant implementation effort when adopting IFRS. The FASB and IASB need to work together on the

financial instruments standard and eliminate the differences in their models. In our view, joint discussions that nevertheless result in two different standards do not constitute a truly joint project. While both the FASB and IASB need to arrive at a single converged standard for financial instruments, the FASB's classification and measurement model with its failure to reflect how businesses are managed has more serious deficiencies that should be corrected in the convergence process. Therefore, we encourage convergence in this area towards the IASB model.

Other comments as well as suggested improvements to the ED are provided in the enclosed Attachment I. Our comments on the specific questions outlined in the ED are included in Attachment II.

We would be pleased to discuss our comments with you at your convenience. Please contact me at 212-559-7721.

Sincerely,

Robert Traficanti
Deputy Controller and Global Head of Accounting Policy

Cc: Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
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Attachment I

We support improvement and simplification.

We strongly support the FASB and IASB's (the Boards) overall objective of reducing complexity in accounting for financial instruments and developing a single converged financial reporting model for financial instruments. Within that single model, it is imperative to have a single impairment model for all financial assets that are not accounted for at fair value with changes recorded through net income. A single impairment model would significantly simplify the existing guidance on accounting for financial assets under both IFRS and U.S. GAAP. However, we regret that the Boards have failed to achieve convergence on this crucial project. In addition, the FASB's version in particular fails the objective of reducing complexity regarding accounting for financial instruments.

Convergence - On a road to convergence, there is a major divergence.

We realize that achieving convergence in accounting for financial instruments is a priority for the FASB and IASB. However, the provisions of the IASB's IFRS 9 on classification and measurement of financial assets, the exposure drafts, *Financial Instruments: Amortised Cost and Impairment* and *Fair Value Option for Financial Liabilities,* and the FASB's proposals in the most critical areas of financial instrument classification, measurement and impairment are significantly divergent. If the goal of a single set of global high quality standards is ever to be achieved, we emphasize the need for convergence in the accounting for financial instruments. If the FASB and IASB finalize different models for financial instruments, the costs to financial institutions and other global companies with subsidiaries that apply IFRS for local reporting would be enormous. Moreover, financial statements of U.S. companies reporting under U.S. GAAP and foreign companies reporting under IFRS would not be comparable. As you know, the Securities and Exchange Commission is working on a timetable for the eventual adoption of IFRS for U.S. registrants. We are very concerned that U.S. GAAP registrants could be required to implement significant changes in U.S. accounting standards for financial instruments that are not convergent with IFRS and shortly thereafter be required to undertake a second significant implementation effort when adopting IFRS.

It is absolutely critical that the IASB and FASB continue to work closely together on their respective financial instruments projects. The most critical area in which to achieve *full* convergence is impairment. If the IASB and FASB finalize different impairment models, the costs to global companies like Citigroup, with many subsidiaries that apply IFRS for local statutory reporting, would be enormous. In addition, there would be a very detrimental impact on convergence and confidence in financial reporting for financial institutions if U.S. GAAP and IFRS differ in such a critical area.

Business model approach: if the business model is to hold, amortized cost is the most appropriate and relevant measure.

Citigroup strongly supports a mixed attribute model for financial instruments that utilizes a combination of fair value and amortized cost. We object to the fair-value-for-almost-all-

financial-instruments approach proposed by the FASB as conceptually flawed. Before issuing a final standard on financial instruments, the FASB should establish a better conceptual framework of the business model for the classification and measurement of financial instruments.

The value of an asset comes from how it will be used to generate earnings for debt and equity holders. The two ways to generate value from any asset, whether plant and equipment or a financial instrument, are either to sell it or generate a return over its useful life. Instead of requiring fair value for all financial instruments, the FASB should establish criteria for when sales value (i.e., fair value through income) or return over useful life (i.e., amortized cost) should be used to reflect the value of an asset in financial statements. There are two criteria for when sales value (fair value measurement) should be used for valuation:

- The firm is not a going concern; **or**
- The firm intends to sell the asset in the course of business or may reasonably be forced to sell the asset given business circumstances.

Similarly, there are two criteria for when return over useful life should be used for valuation:

- The firm is a going concern; **and**
- The firm intends to hold the asset to realize value during the asset's useful life and has the ability to hold the asset during that time period.

Since a vast majority of financial institutions are going concerns, the issue is whether the entity has the intent to realize value through holding the asset over its life, and whether the entity has an ability to hold the asset over the intended value realization period. In addition to intent, which is relatively easy to judge based on history and management's declared intent, one must assess an entity’s ability to hold an asset through adverse periods. If an entity may be forced to sell an asset during an adverse period, then its sales value determines the realizable value.

Assets held to realize long-term value must be supported with long-term funding (long-term debt, core deposits, etc.). If this is done, liability holders cannot force the asset to be sold during liquidity panics.

Behavior during stressed periods must be considered when evaluating the suitability of an appropriate accounting model as behavior during normal unstressed periods is of secondary importance. During stressed periods, sales price is an extremely poor proxy of ultimate realizable value over time. Therefore, sales price should be seen only as an alternative to ultimate realizable value, not a market-based proxy. Sales prices during stressed times reflect investor panic and lack of liquidity, not rational assessment of future cash flows.

The mixed attribute model allows the measurement and reporting of financial instruments to reflect the way these instruments are actually managed. Not all companies follow the same business model, nor do all businesses within a multi-product financial institution have the same model. For example, the investment banking business is involved in more active trading of assets and liabilities, but consumer and corporate banking assets are largely funded by deposits and held longer term. Similarly, the insurance business’ assets are held longer term and their portfolios are designed to provide funding for expected payouts on claims. If the reporting

entity's underlying strategy is to actively trade and benefit from short-term variations in the value of financial instruments, it is appropriate for the entity to report such instruments at fair value and record fair value changes through net income, because fair value represents the most relevant information for financial statement users. However, when an entity does not manage instruments on a fair value basis, amortized cost, which includes adjustments to reflect credit impairment, is the most appropriate way to estimate future cash flows. If a financial instrument is held (or issued) by a business with a strategy to collect (or pay) principal and interest cash flows on an ongoing basis over time without the intent to profit (or requirement to incur losses) from the expected short-term market movements, amortized cost is the most relevant measurement attribute. Moreover, amortized cost information provides users with the ability to forecast cash flows related to those assets and liabilities, whereas fair value information does not.

A requirement to use and report fair value as the default measurement basis for assets and liabilities intended to be held longer term will result in artificial volatility in earnings and other comprehensive income. Using fair value as the measurement basis for most financial instruments would give investors a false sense of the comparability of financial statements of different types of companies (especially among financial institutions), since that presentation would not reflect how the business is managed. Furthermore, net income and balance sheet capital should not be based on different methodologies, since both negative earnings and inadequate capital threaten an entity's viability. With the two-fold accounting model proposed by the FASB, fair value through net income as the default method on the one hand and fair value through OCI if certain criteria are met on the other, a financial institution has to manage to the more conservative of the two impacts. The proposed fair value through OCI alternative would instead distort the results of management's business strategy for non-trading activities for which amortized cost is the appropriate accounting model. While fair value information should be disclosed in the footnotes or parenthetically on the balance sheet, its use as the default measurement basis in the financial statements would not result in the most useful reporting for financial statement users.

The points above do not cover investments in equity securities as there is no pull-to-par similar to debt securities. For equity securities, the current price is the best indicator of future value.

The ED would allow recognition of a financial asset or liability meeting certain criteria at fair value through OCI if the reporting entity's *business strategy for the financial instrument* (per paragraph 21(b)) is to collect or pay the related contractual cash flows, rather than to sell or settle the financial instrument with a third party prior to maturity. Although the FASB's fair value model purports to be a business activity-based model, it is not, since the ED requires that each asset and liability separately meet the criteria for fair-value-through-OCI accounting, rather than requiring a portfolio of assets and liabilities to meet those criteria. As recognized in the Implementation Guidance (paragraphs IG35-36), an entity typically has a strategy for portfolios of financial assets and/or liabilities and manages those portfolios as a unit and, thus, does not have a strategy for the constituent financial instruments. The portfolio strategy may anticipate that some portion of the portfolio will be sold or settled prior to maturity, but such items cannot be identified at the time the financial instrument is acquired, originated or issued. Accordingly, we recommend that paragraph 21(b) of the ED be revised to reflect the fact that a

business strategy may be developed for a portfolio of assets and liabilities, and not only for individual instruments.

Fair value as an accounting measure during a financial crisis

Fair value could be a valid accounting method for two reasons. First, if one intends to sell an asset, the market price is relevant because it is the best estimate of the sales price. Second, if one intends to hold an asset, the market price may be seen as the market's best estimate of the net present value of the cash flows to be realized in the future.

As noted above, behavior during stressed periods, which is the most important time to test the credibility of market price as the measure of value, must be considered when evaluating the suitability of an appropriate accounting model. First, during a financial crisis, the difference between prices and historical cost is the greatest, so we must be sure which measure is right at that time. Second, that is when the fair value matters most to investors and regulators. If market price is nearly right 95% of the time during calm periods and seriously wrong 5% of the time in crisis periods, it would be an unacceptable measure.

Citigroup has conducted a study of bond spreads as of December 31, 2008 versus subsequent default losses on these bonds (table below). The spreads are based on all the bonds in Citi's internal fixed income data base. We focus on bonds with a 2-year maturity, because we have a clear idea of the default losses on those bonds to their maturity at December 31, 2010. Losses during 2009 reflect actual losses as determined by Moody's annual bond default study. There is a minor amount of speculation about losses to be realized in 2010 because the year has not yet ended. The default losses for 2010 reflect Moody's estimate of average losses through the cycle. This is conservative because default losses during 2010 are predicted by Moody's to be below historical averages.

Bond Rating	Spread over risk-free rate (swap)	Actual annual default losses to maturity	Ratio of spread to actual default losses
AAA/AA	471 bp	0.6 bp	785x
A	534 bp	7 bp	75x
BBB	1,003 bp	30.5 bp	33x
BB	1,440 bp	112 bp	13x
B	2,614 bp	382 bp	7x

The results above are comparable because both the spread and annual default losses measure the product of annual default probability multiplied by the loss given default. We expect spreads to be above actual default losses, because spreads include a risk premium while actual default losses do not. However, it is clear that the predicted level of losses, as represented in the spread over the risk-free rate, is far above the actual level. (Note that the ratios above are multiples, not percents. For A-rated names, the ratio is 75 times and the percent error is 7500%).

We conclude that spreads reflect market panic and forced selling due to lack of liquidity, not a reasoned discount of future default losses. This price is meaningful if the bond will be sold, but not an improvement over historical cost for an asset that is to be held to maturity.

We support IASB's classification and measurement model (IFRS 9).

The IASB's mixed attribute classification and measurement model, overall, is conceptually superior to the FASB's proposed fair-value-for-almost-all-financial-instruments approach. We therefore encourage convergence in this area towards the IASB model, as it allows the measurement and reporting of financial instruments to reflect the manner in which these instruments are actually managed.

However, we disagree with the lack of "recycling" in the guidance issued by IASB. According to IFRS 9, an entity can elect on initial recognition to present changes in the fair value of an equity investment that is not held for trading directly in OCI. While dividends on such instruments are recognized in income, realized gains or losses are never recycled. Also, in their exposure draft on financial liabilities, the IASB proposes that changes in fair value related to own credit risk should be recorded in OCI even for liabilities classified as fair value through net income. However, the impact of changes in own credit risk would not be subsequently reclassified to earnings when the liability matures or is settled. Realized gains or losses should always be recorded in earnings, rather than left permanently in OCI. Hence, our view is that in both cases above, a gain or loss recognized in OCI should be recycled to earnings at the time it is realized when the equity security is sold or the liability extinguished.

Subsequent measurement

Foreign currency transaction gains/losses on items measured at fair value through OCI
We strongly object to the proposal in the ED that foreign currency transaction gains/losses on items accounted for at fair value through OCI should be recorded in OCI. This is currently a significant difference between U.S. GAAP and IFRS, and we see no reason why the proposals in the ED represent an improvement in financial reporting. We understand that Emerging Issues Task Force (EITF) Issue No. 96-15, *Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities*, required transaction gains/losses to be recorded in OCI as a practical exception to the key principles in FASB Statement No. 52, *Foreign Currency Translation*, and to relieve certain of the measurement issues raised by holding foreign-currency-denominated debt securities. IAS 39 has always required such transaction gains/losses to be recognized in earnings and provides implementation guidance for measuring those amounts. In our experience, financial institutions have been able to apply these requirements in IAS 39 with little or no difficulty. The proposals in the ED would significantly expand the population of financial assets *and* financial liabilities for which foreign currency transaction gains/losses are not recorded in earnings. In our view, the Board did not adequately address the principles underlying this proposal or the significant and pervasive effect that it will have on reported earnings.

Most financial institutions economically hedge foreign currency risk between their assets and liabilities, whether such assets and liabilities are accounted for at fair value through earnings, fair value through OCI, or amortized cost. It should not be necessary to layer on complex fair value hedge accounting programs to permit foreign currency gains/losses to be reclassified from OCI to earnings. Such hedge programs are required under U.S. GAAP today. For example, Citi often holds foreign-currency-denominated AFS debt securities that are funded by (and economically hedged with) foreign-currency-denominated debt or deposit liabilities. In order to

avoid significant, random and misleading income statement volatility (because transaction gains/losses on the liabilities are recorded in earnings, while offsetting losses/gains on the debt securities are recorded in OCI), U.S. GAAP requires the application of fair value hedge accounting programs of foreign currency risk on the AFS debt securities. The notional amounts of such hedge programs would increase exponentially under the FASB's proposals, even when a financial institution has foreign-currency-denominated assets and liabilities accounted for at fair value through OCI. This is because assets and liabilities will not mature at the same time, resulting in realized gains/losses at maturity of the assets and liabilities being reclassified to earnings in different periods. Such implementation issues could be avoided, U.S. GAAP and IFRS could be converged in this area, and U.S. GAAP could be significantly simplified and improved by having the principle that **all** foreign currency transaction gains/losses should be recorded in earnings. We request that the Board address this issue in more detail during its redeliberations.

Equity Investments
Citigroup supports the proposal for all equity instruments that are not subject to equity method of accounting to be accounted for at fair value through net income, because it simplifies the current mixed measurement model.

However, we disagree that the equity method should only be permitted when the operations of the investee are related to the entity's consolidated business. The criteria for using the equity method are inconsistent with the Board's consolidation model for variable interest entities (VIE) and controlled non-VIEs, where there is no requirement that a VIE's or controlled non-VIE's operations be related to the parent's consolidated operations.

Under Accounting Standards Codification (ASC) Topic 323-30-555 and 599 (formerly EITF Topic D-46), investors are currently required to apply the equity method to investments in limited partnerships and LLCs unless the investors' interests are considered so minor (deemed to be less than 3% to 5%) that the investor has virtually no influence over the partnership's operating and financial policies. It is unclear whether such an investment would be considered "significant" under the ED.

As a result of the ED's proposed changes to the criteria to qualify for the equity method of accounting, certain investments in limited partnerships and limited liability companies that currently use the equity method of accounting may now be required to be recorded at fair value through net income, because the operations of these entities are deemed to be unrelated and/or the investor is not considered to have significant influence over the investee. However, the financial information needed to determine fair value for these private companies may not be available to the reporting entity on a timely basis. Therefore, additional implementation guidance should be provided for unlisted equity instruments in the joint FASB/IASB project on fair value measurement.

Similarly, a practicability exception should be available for equity investments that currently do not meet, but are expected to meet the revised criteria for equity method accounting when information required to apply equity method of accounting may not be available on a timely basis. The fair value option should be available for such investments, particularly since fair value through net income is the default methodology for all financial instruments.

Own Credit Valuation Adjustments
The exposure draft requires certain disclosures of a company's own Credit Valuation Adjustment (CVA) and the impact of own credit on the changes in fair value for derivative instruments and liabilities required to be reported at fair value. The own credit valuation adjustment will be measured by isolating the company's credit spread, independent of the spread that relates to the sector spread of those with similar credit standing. This approach is complex, quite subjective, differs from the way the market considers a company's credit risk and is potentially misleading. The methods described in the draft begin with a ratings approach, but ratings tend to be lagging indicators. Additionally, identifying "similar" institutions is highly subjective and may be difficult. When the market discusses credit, it focuses on the cost above some benchmark rate, such as U.S. Treasury securities, rather than the rate that would be required to be used for the CVA disclosure under the ED. See our further comments and responses to Questions 32 to 34 in Attachment II below.

Hybrid Instruments
We support the proposals in paragraph 21(c) of the ED. We believe the FASB's proposed guidance in paragraph 21(c) of the ED is more appropriate than the IASB's guidance on assessing the contractual cash flow characteristics of financial instruments. If the FASB and IASB worked together to incorporate those relatively minor changes to the decisions reached by the IASB in IFRS 9, Citi believes the Boards could achieve convergence while significantly simplifying and improving the classification and measurement guidance.

Sales of Assets Reported at Fair Value through OCI
The ED states that there is no tainting concept relating to sales of assets or settlements of liabilities that are reported at fair value through OCI. However, the ED does not provide sufficient guidance about what might be an acceptable rate of sales/settlements of instruments eligible for this classification. A lack of clarity in this area could lead to disagreements among financial statement preparers, auditors and regulators. If such sales/settlements were considered to be too frequent, could the OCI book be considered tainted under any circumstances or would the reporting entity be precluded from using the fair value through OCI classification for newly originated or purchased financial instruments?

Market-making in Own Debt
The ED would permit an entity to recognize a qualifying portion of a change in fair value of a financial instrument in OCI if, among other things, the entity's business strategy for the instrument is to collect or pay the related contractual cash flows rather than to sell the financial asset or settle the financial liability with a third party.

It is common for financial institutions' trading desks to make a secondary market in their own debt. The purpose of this activity is to support market liquidity for their own debt by facilitating customer transactions and normal market buying and selling activity. Generally, the issuing financial institution is the only market-maker for the debt that it issues. The own debt reacquired is normally held for only a short period of time before it is reissued to third parties.

Although the temporary acquisition of own debt could be viewed as settling the liability before its contractual maturity, this market-making in a financial institution's own debt is not contradictory to a business strategy of paying all of the related contractual cash flows. The purpose of issuing debt is to raise funds and the reacquired debt is ultimately sold relatively

quickly and therefore by-and-large remains outstanding during its entire contractual life. Accordingly, Citigroup is requesting that the FASB clarify that such market-making is not contrary to an assertion that the entity has a business strategy of not settling liabilities prior to contractual maturity.

Impairment

Purchased Assets

There is no conceptual basis to have different accounting for originated assets and assets purchased with a discount related to credit quality. Under FASB's proposed model, there would be a significant expansion of a model with provisions similar to ASC 310-30 (formerly SOP 03-3) that would apply to all financial assets purchased at an amount that includes a discount related to credit quality, for example, purchased loans and debt securities carried at fair value through OCI. These new bookkeeping requirements will be even more extensive than under SOP 03-3 for many purchased financial assets, whose scope only applies to purchased impaired loans, because the effective interest rate would need to be re-determined each period when cash flow expectations change. SOP 03-3 has been very difficult for financial institutions to implement as no satisfactory reporting systems have been developed that meet all its requirements for acquired impaired loans. With the changes to the overall impairment model, a separate credit impairment model for purchased assets is no longer justified. Rather, there should be one model for individually evaluated assets and one for assets evaluated for impairment as part of a pool of similar assets. These models should cover both purchased and originated assets within each category.

Non-accrual Assets

The non-accrual provisions of the ED are concerning. The proposal would create a regulatory reporting (RAP) to GAAP difference and would be difficult to implement operationally. Furthermore, for U.S. banks, the number of assets that would be classified as non-accrual under GAAP would significantly decrease, relative to the amounts that are currently reported. This would decrease the transparency of financial institutions' financial statements and possibly affect the usefulness of certain important and widely used credit metrics for analysts (i.e., non-performing loan statistics).

More specifically, the ED seems to require the non-accrual provisions to be applied to individual assets. Given that most consumer loans (i.e., residential mortgages, credit cards, installment loans) are evaluated for impairment at a pool level, a yield analysis at the individual asset level, as required by the non-accrual provisions of the ED, is operationally impossible. However, if a pool-based non-accrual analysis were allowed for small homogeneous loans, it is likely that most pools would not meet the proposed criteria for non-accrual even when some individual loans in the portfolio are past due and would qualify as non-accrual today (i.e., total expected cash flows for the pool would exceed the remaining principal balance of the loans in the pool). As a result, the population of non-accrual consumer loans reported under GAAP would be insignificant.

Further, the Board notes they believe that general non-accrual guidance could not be developed to fit all situations. We disagree; there is existing Federal Financial Institutions Examination Council (FFIEC) guidance that is established for U.S. banks that would be easily transferrable for GAAP reporting. The FFIEC definition for non-accrual loans is as follows: "General rule –

Banks shall not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset (1) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) for which payment in full of principal or interest is not expected, or (3) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection." This long-standing definition has been applied in practice by U.S. banks in the non-accrual loan disclosures required under the Securities Act Industry Guide 3, "Statistical Disclosure by Bank Holding Companies," in their Form 10-K reporting. Therefore, if the ED's proposed definition of non-accrual is retained in the final standard, future Guide 3 reporting would reflect non-accrual loans on a different basis than in the past. In addition, U.S. banks will continue to use the regulatory definition of non-accrual loans in their "Consolidated Reports of Condition and Income for a Bank" (Call Report). As a result, there will be a RAP/GAAP difference for the reporting of non-accrual loans by U.S. banks.

Hedging

Hedging Specific Risks
In a step toward simplification and convergence with IFRS, we support allowing an entity to hedge specified risks of a hedged item, so long as the risk is identifiable and measurable. ASC Topic 815 presently limits the types of interest rate risk that can be separately hedged to those which are benchmark interest rates. However, companies regularly hedge risk associated with other stable and regularly reported rates (for example, the federal funds rate). Absent an ability to designate certain interest rate risks beyond benchmark rates, certain valid and effective hedges result in significant income statement volatility. The proposal should permit designation of other common interest-rate-related exposures, such as the federal funds rate, the prime rate and inflation.

Further, non-financial risk components should be permitted to be designated as hedged risks. Past guidance from the IASB has provided the required conditions for designation. We suggest that the FASB monitor the IASB's amendment to hedge accounting and similarly permit designation of separately identifiable and reliably measurable nonfinancial risks. Separately identifiable nonfinancial components are best exemplified by commodities, including the following:

- Refined sugar: Price is a function of domestic #14 sugar futures prices, refinery margin, refinery loss, brokerage, freight cost and grade differential;
- Corn: Price is a function of CBOT corn futures price, basis difference for specific locations and grade premium; and
- Natural Gas: Price is a function of NYMEX natural gas futures price, basis difference for specific location and distribution costs.

Simplifying Ineffectiveness Calculations
Given the proposed elimination of the shortcut method, many companies will need to establish processes and controls to facilitate long-haul calculations of ineffectiveness. Accordingly, companies will need to consider the impact of credit valuation adjustments to the hedged item and the hedging instrument. This increases complexity and will result in more ineffectiveness reported through earnings. In a step toward simplicity, we suggest that the FASB eliminate

counterparty credit risk valuation adjustments from the measurement of ineffectiveness unless/until there are significant credit concerns for the hedging entity or its counterparty.

Accounting for Option Time Value

The proposal permits an entity to include time value in its assessment and measurement of hedge effectiveness, but requires its impact to be reflected in earnings on a "rational basis." We recommend that the FASB clarify what it means by "rational basis." It is not clear whether or when the FASB intends for option time value to be amortized to earnings over the life of the hedge or to be included in earnings when the hedged item affects earnings (as is currently permitted under DIG Issue G20).

Attachment II

Scope

Questions for All Respondents

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?

We generally agree with the scope of financial instruments included in the ED. However, with respect to guarantees (other than derivative guarantees), it is not clear whether the guaranteed parties are exempt from the scope. Since insured parties are out of scope as well as borrowers under loan commitments and letters of credit, we think that guaranteed parties should also be exempt from the scope of the ED. Therefore, we are asking for clarification in the final standard of whether guarantees from the perspective of guaranteed parties are scoped out.

Also, in line with our response to Questions 18 and 21, we recommend that the FASB leave the existing framework for financial liabilities, including convertible debt, unchanged. If the FASB decides to persist with the proposals for financial liabilities, we recommend that, at the very least, convertible debt should be eligible for subsequent accounting at fair value through OCI or amortized cost through a specific scope exception from the provisions of paragraph 21(a)(1).

Question 2: The proposed guidance would require loan commitments, other than loan commitments related to a revolving line of credit issued under a credit card arrangement, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

We agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope. We believe this is appropriate, because such lines are cancelable at will by the issuer and the terms of the lines of credit can also be changed upon giving notice to the card holder, whereas with other loan commitments there is a contract with the borrower that may not be changed without borrower consent to the revised terms. As such, it would be very difficult to determine the fair value of these lines of credit. However, the FASB should clarify in the Basis for Conclusions the principle governing why these arrangements are excluded. Stating the principle would assist in determining whether it is possible that other loan commitments that are similar to credit card loan commitments (i.e., mortgage loan commitments that are cancelable by the issuer at any time) should be excluded as well.

Question 4: The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity's consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?

We disagree with the ED's proposed elimination of the fair value option for entities that would otherwise be required to account for their investments under the equity method where the

investor has significant influence over the investee and the operations of the investee are considered related to the investor's consolidated operations. Entities often do not have access to the detailed information needed to apply the equity method of accounting to an investment (or may not have access to it on the timely basis needed for financial reporting). In those situations, investors should be allowed to elect to account for these investments at full fair value with changes in fair value recorded through income as is currently allowed.

Moreover, we object to the requirement that the equity method only be permitted when the operations of the investee are related to the entity's consolidated business. The criteria for using the equity method are inconsistent with the Board's consolidation model for VIEs and controlled non-VIEs where there is no requirement that a VIE's or controlled non-VIE's operations be related to the parent's consolidated operations.

Under EITF Topic D-46, investors are currently required to apply the equity method to investments in limited partnerships and LLCs unless the investors' interests are considered so minor (deemed to be less than 3% to 5%) that the investor has virtually no influence over the partnership's operating and financial policies. It is unclear whether such an investment would be considered "significant" under the ED.

Questions for Users
Question 5: The proposed guidance would require financial liabilities of investment companies to be measured at fair value with changes in fair value recognized as a net increase (decrease) in net assets. Do you believe that the effect on net asset value will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why?

The ED requires investment companies to measure their financial assets and liabilities at fair value and include all changes in their fair value in the net increase (decrease) in net assets for the period. Neither the option to report changes in the fair value in OCI nor the amortized cost option for qualified financial liabilities is available to an investment company. This could be problematic for investors in a leveraged investment company, since its shares are redeemed at a net asset value that reflects the contractual amount (amortized cost) of the company's liabilities. Accordingly, amortized cost is a more relevant measure. Otherwise, investment companies would be reporting a GAAP net asset value based on liabilities at fair value, while the net asset value used for redemptions is determined based on liabilities reported at amortized cost.

Question 7: The proposed guidance would require brokers and dealers in securities to apply the proposed guidance for measuring financial liabilities, which could mean that qualifying changes in fair value would be recognized in other comprehensive income. Do you believe that this will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why?

For brokers and dealers in securities, the proposed guidance for measuring financial liabilities would result in fair value accounting with changes in fair value recorded either in earnings or other comprehensive income. We do not believe either of those classification and measurement alternatives provides decision-useful information. Instead, we support the existing framework in GAAP for financial liabilities which would result in non-trading financial liabilities (i.e.,

plain vanilla debt) being accounted for at amortized cost. For further discussion of our views on measuring financial liabilities, please see our response to Question 18 below.

Initial Measurement

Questions for All Respondents
Question 8: Do you agree with the initial measurement principles for financial instruments? If not, why?

We agree that a financial instrument that is subsequently measured at fair value through earnings (i.e., trading instruments) should be initially measured at fair value. Although we disagree with the proposed subsequent measurement of fair value through OCI for other financial instruments (non-trading instruments), we do agree that the initial measurement for those financial instruments should generally be the transaction price.

Question 9: For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

Fair value may also be different from the transaction price because there is no observable fair value. There should be no charge to earnings on day one as a result of a difference between the transaction price and the fair value, except to recognize rights and privileges that are covered by the transaction price. All unstated rights and privileges should be identified and measured; however, if there are no such rights or privileges, the transaction price should be the initial measurement amount.

Question 10: Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?

See our comments on the classification and measurement model and convergence in the cover letter and in Attachment I above.

Question 11: Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

It is appropriate to immediately expense transaction fees and costs for financial assets measured at fair value with changes recorded in net income. Also, we agree the deferral and amortization of asset origination fees and costs as an adjustment to the asset's yield would be appropriate for other financial assets that are not measured at fair value through net income. Additionally, we think that both the borrower and the lender should have the same accounting treatment. Thus, it

is appropriate to defer and amortize debt issuance costs and fees as well, since the debt of one entity is the loan of another.

Question for Preparers and Auditors
Question 12: For financial instruments initially measured at the transaction price, do you believe that the proposed guidance is operational to determine whether there is a significant difference between the transaction price and fair value? If not, why?

No. It would be operationally cumbersome to determine whether a transaction price is different from fair value and the additional effort to do so would provide an insufficient benefit. See our response to Question 9 above as well.

Subsequent Measurement

Questions for All Respondents
Question 13: The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

We agree that the default measurement attribute for financial instruments held for trading purposes should be fair value; however, financial instruments held for other business purposes should not be measured at fair value. We agree with the Alternative Views expressed by Leslie Seidman and Lawrence Smith in paragraph BC244, where they "dissent from several aspects of the proposed guidance, primarily because it would introduce fair value accounting for some nonmarketable, plain-vanilla debt instruments that are held for collection (long-term investment), and most liabilities held for payment, which they believe would not reflect the likely realization of those items in cash and, therefore, would not be the most relevant way to measure those items in the statement of financial position and comprehensive income."

We support a mixed attribute accounting model for financial instruments over the fair-value-for-almost-all-financial-instruments approach proposed by the FASB. Through the utilization of fair value and amortized cost, the mixed attribute accounting model allows the measurement and reporting of financial instruments to reflect the way these instruments are actually managed. The ED would allow recognition of a financial asset or liability meeting certain criteria at fair value through other comprehensive income (OCI) if the reporting entity's *business strategy for the financial instrument* is to collect or pay the related contractual cash flows, rather than to sell or settle the financial instrument with a third party. However, a reporting entity has a strategy for a portfolio of financial assets and/or liabilities and manages the portfolio as a whole; the entity does not have a strategy for individual financial instruments. The portfolio strategy may result in a particular asset being sold prior to maturity, but the identification of which asset will

be sold or which liability will be settled prior to maturity cannot be identified when the instrument is acquired, originated or issued.

An amortized cost accounting model is a better representation of the business strategy of holding non-trading financial instruments for collection or payment. While fair value through net income is an appropriate accounting model for trading businesses, fair value either through net income or OCI does not best reflect the activities of a business that is managed for cash flow and liquidity management purposes. For such a non-trading business, fair value does not help a financial statement user to project the business' cash flows, revenues or expenses. As a result, the financial statements would provide a less transparent view of the entity's business operations and its performance.

For these reasons, the IASB's mixed attribute classification and measurement model for financial instruments in IFRS 9, *Financial Instruments*, the Exposure Draft, *Fair Value Option for Financial Liabilities,* and IAS 39, *Financial Instruments: Recognition and Measurement*, while not perfect, is superior to the FASB's proposed classification and measurement model. However, there are aspects of the IASB's classification and measurement model that we do not support, including not allowing recognition of unrealized gains and losses in net income when they are realized (that is, no "recycling") and to the differing treatment of hybrid assets and liabilities.

Also, see our comments in the cover letter and Attachment I above.

Question 14: The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?

Citigroup agrees that interest income and expense, credit impairments and reversals and realized gains and losses should be recognized in net income for financial instruments; however, we do not agree with the ED's proposals for measuring interest income, credit impairments and recoveries of impairments. See our cover letter and our responses to Questions 37, 38 and 48.

According to paragraph 46 of the ED, changes in cash flows expected to be collected that relate to changes in foreign exchange rates used to remeasure foreign-currency-denominated financial assets should not give rise to credit impairment. While we agree that declines in value related to changes in foreign-currency exchange rates (FX impairment) should not be recorded as credit impairment, the ED is not clear what approach, if any, should be used to evaluate when FX impairment has occurred and should be recorded in earnings. The ED seems to indicate (although it is not clear) that an entity would defer all foreign currency rate-change-related gains and losses in OCI until the asset is sold or settled at maturity. We support recording **all** foreign currency transaction gains/losses in earnings, rather than in OCI (except instruments that are designated and qualify as net investment hedges). See our comments on this issue in the section entitled *Foreign currency transaction gains/losses on items measured at fair value through OCI* in Attachment I.

Question 15: Do you believe that the subsequent measurement principles should be the same for financial assets and financial liabilities? If not, why?

Subsequent measurement principles should be the same for financial assets and financial liabilities. However, we do not support the subsequent measurement principles proposed in the ED. Amortized cost is the most appropriate measurement attribute for many financial liabilities, because it reflects the issuer's legal obligation to pay the contractual amounts in the normal course of business and in most cases the issuer plans to hold liabilities to maturity and pay the contractual amounts. Financial instruments held for the collection/repayment of contractual amounts should be recorded at amortized cost and not fair value. See our detailed response to Question 18 below.

Question 16: The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?

No. We do not agree that an entity should be prohibited from changing the measurement attribute for its financial assets and liabilities. There are occasions when an entity's business strategy for a subsidiary or a portfolio of assets changes due to changing business priorities and/or stressed or more favorable economic conditions. As a result, the entity's intentions regarding whether or not it is holding a financial asset or liability (or portfolio of assets and liabilities) for longer term cash flow purposes, can change. To require continued application of an accounting model that does not reflect the entity's current business strategy is inappropriate in our view. IFRS 9 correctly allows redesignation of the accounting classification for a financial asset when the business purpose changes. We would expect that any such material change in business model would be infrequent.

Question 17: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

The remeasurement approach is not appropriate, as it is based on flawed logic, will add complexity to financial reporting and will make financial statements less transparent and comparable. The Board has not satisfactorily demonstrated the need for or the benefits of this new and highly subjective valuation model, the introduction of which is contrary to any intent to reduce complexity in financial reporting.

The proposed guidance will create confusion by redefining the term “core deposits.” The commonly accepted definition of core deposits is based on regulatory guidance and describes that portion of a bank's deposit base that is expected to remain with the bank over a longer term, is not limited solely to demand deposits and is not segregated and measured as it relates to specific deposit products. Thus, a bank’s "core deposit" is related to the structural liquidity component of the deposit base and is not limited by interest rate characteristics as they pertain to individual demand deposit products.

Under the proposed guidance, Board-defined criteria will be used to identify, segregate and remeasure certain subsets of deposits currently considered to be “core,” with the periodic remeasurement derived using a calculation in which the estimated cost of replacing the deposits with a mix of alternate borrowings is compared to the Board-defined “all-in-cost-to-service” deposits.

The usefulness of the information produced by this academic exercise is not clear. Elements of the calculation are not consistent with economic realities and will be derived from highly subjective assumptions. As a result, the calculation has little economic meaning, as evidenced by the fact that resulting carrying values will not represent the fair value, acquisition value or liquidation value of the remeasured deposits.

The concept of remeasuring a core deposit liability implies that some deposits are “below market” and require an adjustment to their carrying values. While it is clear that demand deposits command a lower cost of funds than many other types of borrowings, that cost of funds effectively is “at market” and consistent for all institutions that accept demand deposits, and reflects the immediate availability and governmental protection afforded to the deposits.

We understand the Board’s position that there is a component of the deposit base that provides a stable funding source and has a value that is likely greater than par. However, that value relates to the net revolving activity of a pool of deposit accounts and not to a specific pool of deposit balances. Generally accepted accounting principles recognize this distinction as the difference between a core deposit intangible and a demand deposit liability, which although related, should not be combined. As a result, it is inappropriate to adjust the carrying value of the latter for component changes in the value of the former.

Further to the above, we point out the following additional items of concern to the Board:

- Artificially adjusting a portion of the cost of funding for a banking entity does not make that entity’s financial statements comparable to a non-banking entity. In reality, it will make the financial statements less comparable, because it is flawed to remeasure core deposits as if they were replaced with more expensive borrowings, but not allow any reassessment of the benefits that were provided by those deposits. The remeasurement approach does not recognize that a banking entity would either not maintain a similar level of borrowings if they were more expensive or alternatively would price its lending products to absorb a higher cost of borrowing if that higher cost were actually incurred. Thus, the remeasurement approach presents an incomplete picture by adjusting only one side of the equation and, as a result, it makes financial statements less meaningful and comparable. Therefore, we believe that this remeasurement approach is not appropriate

and the remeasurement amount should not be presented in the financial statements or disclosed in the notes.

- If the Board does not agree with the foregoing and continues to believe the remeasurement approach provides an appropriate representation of the carrying value of certain deposit liabilities, a more compelling case must be put forward to support this creation of not only a new unit of accounting, but also an entirely new concept of "remeasurement" and a related methodology to "value" that unit of accounting.

- A change in financial reporting of this magnitude should be in response to a specific demand from financial statement users. However, we are not aware of any parties calling for this information as necessary to have more transparent and meaningful financial statements, especially since the carrying values produced by the methodology do not represent any economic reality and are thus not useful or actionable.

Further to this response regarding the propriety of the remeasurement approach, please see our response to Question 31 for additional considerations regarding the operationality of the proposed guidance. In addition, if the Board decides to retain the proposed remeasurement approach for core deposits, examples are required to illustrate how it would be accomplished, including how the components of the all-in-cost-to-service rate and the alternative funds rate are to be determined.

Question 18: Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?

Citigroup does not support the classification and measurement framework for financial liabilities as proposed in the Exposure Draft. The proposed framework for financial liabilities, similar to that for financial assets, will generally result in the measurement at fair value through earnings unless a set of conditions is met for classification as fair value through OCI or amortized cost.

In contrast to the sweeping changes proposed by the FASB with respect to financial liabilities, the IASB has proposed to retain existing requirements of IAS 39, *Financial Instruments: Recognition and Measurement*, with the exception of certain proposed changes to liabilities designated under the fair value option. Under the IASB's proposed approach which Citigroup supports, financial liabilities would continue to be accounted for at amortized cost or at fair value through earnings (if classified as held-for-trading or if the fair value option is selected). Embedded derivatives would be bifurcated if they are not clearly and closely related to the host and subsequently accounted for at fair value through earnings. The only significant change to existing accounting is the IASB's proposal as it relates to the subsequent measurement of liabilities designated under the fair value option. The IASB has proposed that all changes in fair value (including own credit) would still be recorded in earnings. However, the portion of the changes in fair value that relates to the entity's own credit would be transferred from earnings to OCI. Amounts recorded in OCI would not be subsequently recycled though earnings upon derecognition of the liability (see our comments on recycling below). As discussed in the Basis

for Conclusions of ED/2010/4, *Fair Value Option for Financial Liabilities*, the IASB arrived at this approach after an extensive outreach program to gather feedback on the classification and measurement of financial liabilities. The feedback received from various constituents (Financial Instruments Working Group, users, regulators, preparers, auditors and others from a range of industries across different geographic regions) was:

- Amortized cost is the most appropriate measurement attribute for many financial liabilities, because it reflects the issuer's legal obligation to pay the contractual amounts in the normal course of business and in most cases the issuer plans to hold liabilities to maturity and pay the contractual amounts;
- The bifurcation methodology in IAS 39 is generally working well and consistent and well established practices have developed among preparers;
- Effects of changes in a liability's credit risk should not affect profit or loss unless the liability is held for trading; and
- Symmetry between how an entity classifies and measures its financial assets and liabilities is not necessary and often does not result in useful information.

The feedback that the IASB received from its outreach activities is directly relevant to the proposals in the Exposure Draft. As discussed in the Basis for Conclusions in the Exposure Draft, the primary justification for the proposed approach seems to be the FASB's belief that it would decrease the mismatch that exists between the asset and liability side of the balance sheet. This issue has already been addressed through the availability of the fair value option (under ASC 825-10-25), which enables preparers to identify specific situations where such a mismatch exists, and then resolve it by electing to fair value the asset and/or liability at inception. We note that under the IASB proposals, both loans and deposits would be recorded at amortized cost, while under FASB's proposals loans would be recorded at fair value and core deposits using a present value remeasurement approach.

The IASB's approach of retaining most of the existing classification and measurement framework for financial liabilities is preferable to the changes proposed by the Exposure Draft. We support the IASB's proposal in ED/2010/4 that addresses the issue of own credit risk, while acknowledging that own credit on derivative liabilities should be reflected in earnings. However, all realized gains and losses should be recognized in earnings and, accordingly, we recommend that changes in own credit recorded in OCI be recycled to earnings if they are realized and not left in OCI permanently.

In summary, Citi strongly urges the FASB to adopt the approach taken by the IASB and retain the existing accounting framework for financial liabilities that is well understood and results in meaningful financial statements. Some of the issues with the existing framework of financial assets (e.g., multiple categories, delayed recognition of losses) simply do not apply to the existing framework for financial liabilities. In our view, the only significant issue affecting the framework for financial liabilities is the impact of own credit risk. However, this can be resolved by simply making an incremental change similar to the one proposed by the IASB in ED/2010/4 instead of the wholesale changes proposed in the Exposure Draft. Finally, the continued existence of the fair value option will enable preparers to resolve mismatches between assets and liabilities when necessary, which seems to be the FASB's primary concern.

Question 19: Do you believe that the correct financial instruments are captured by the criteria in the proposed guidance to qualify for measurement at the redemption amount for certain investments that can be redeemed only for a specified amount (such as an investment in the stock of the Federal Home Loan Bank or an investment in the Federal Reserve Bank)? If not, are there any financial instruments that should qualify but do not meet the criteria? Why?

Subject to our comments about FASB's proposed classification and measurement as a whole, we support the guidance in paragraph 34, which addresses subsequent measurement for restricted types of assets.

Federal Home Loan Bank (FHLB) stock has long been evaluated using an ultimate recoverability threshold (ASC 942-325-35-3). When this guidance was first developed as part of the AICPA Audit and Accounting Guide for Banks & Savings Institutions, and later included in SOP 01-6, the AICPA's belief was that the evaluation should be performed based on ultimate recoverability given the uniqueness of this asset, particularly as a government-sponsored entity. The criteria included provided a vehicle to assess ultimate recoverability. For FHLB stock, impairment should be measured based on ultimate recoverability (using the existing criteria in ASC 942-325-35-3), rather than using the impairment guidance as proposed in paragraph 37(c) of the ED. Citi believes that Federal Reserve stock should also be measured based on ultimate recoverability. FHLB and Federal Reserve stock are unique investments with ties directly to the U.S. Government.

Question 20: Do you agree that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income in combination with other deferred tax assets of the entity (rather than segregated and analyzed separately)? If not, why?

We do not support the proposal requiring an entity to consider its deferred tax assets related to debt instruments for which qualifying changes in fair value are recognized in other comprehensive income in combination with its other deferred tax assets in evaluating the need for a valuation allowance as part of this ED. We are concerned that the FASB is addressing this one area of income tax accounting guidance in isolation without a full consideration of the judgments that are necessary to evaluate the need for a valuation allowance on a deferred tax asset related to such investments in debt instruments. Additionally, this proposal does not comply with one of the stated objectives in the ED, to reduce complexity, as it proposes to limit the judgments that are currently necessary to comply with the income tax accounting framework provided by ASC 740 and thus establishes a bright-line rule.

As background, the rationale for the approach that the FASB is proposing to eliminate is based on the premise that if an entity has the intent and ability to hold the debt instrument until the recovery of its amortized cost basis (which may be at maturity), increases and decreases in the debt instrument's fair value will reverse out of other comprehensive income over the contractual life of the investment. This results in no cumulative change in the entity's comprehensive income or future taxable income over that contractual life. In this respect, the temporary differences associated with unrealized gains and losses on debt instruments are unlike other types of temporary differences, because they do not affect the income statement or the tax return

if held until recovery of the debt securities' amortized cost. This approach is limited to debt instruments with contractual maturity dates.

Many judgments are made when assessing the realizability of deferred tax assets. ASC 740-10-30-18 states, "Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law." That paragraph also includes numerous examples of the types of information that is considered in making such realization assessments. If an entity has the ability to hold an investment in a debt security until its recovery or maturity, the recovery of the fair value of the debt instrument and the corresponding reversals of the deferred tax asset can be viewed as a realization of the tax benefit.

Alternatively, some have taken the view, that a deferred tax asset related to a debt instrument should be considered in combination with other deferred tax assets but the entity may assert it has a tax planning strategy such that any future increases in the value of the debt instrument to the maturity date of the instrument can be considered when determining whether its deferred tax assets are realizable. This approach could be considered in compliance with the rule proposed in the ED, but may provide a result similar to the approach described above. It is unclear whether the proposal in the ED was intended to disallow this "tax planning strategy" approach or whether the FASB considered this current practice in coming to its conclusion.

For these reasons, if the FASB desires to eliminate the diversity in practice regarding income tax accounting guidance, it should do so in a comprehensive income tax accounting project. This proposal has little to do with the accounting changes being proposed for financial instruments in the ED. If the FASB rejects our recommendation to remove this proposal from the ED, it should consider the issue more completely and determine if more guidance should be provided on how the phenomenon of holding a debt instrument measured at fair value with certain changes being recorded in other comprehensive income should be considered when assessing the related deferred tax assets for realizability.

Question 21: The Proposed Implementation Guidance section of this proposed Update provides an example to illustrate the application of the subsequent measurement guidance to convertible debt (Example 10). The Board currently has a project on its technical agenda on financial instruments with characteristics of equity. That project will determine the classification for convertible debt from the issuer's perspective and whether convertible debt should continue to be classified as a liability in its entirety or whether the Board should require bifurcation into a liability component and an equity component. However, based on existing U.S. GAAP, the Board believes that convertible debt would not meet the criterion for a debt instrument under paragraph 21(a)(1) to qualify for changes in fair value to be recognized in other comprehensive income because the principal will not be returned to the creditor (investor) at maturity or other settlement. Do you agree with the Board's application of the proposed subsequent measurement guidance to convertible debt? If not, why?

The FASB and the IASB have made significant progress on the project on financial instruments with characteristics of equity prior to deferring further deliberations as a result of the revised timeline published in [July] 2010. Tentative conclusions arrived at as part of this project would

require that debt instruments that are convertible, at the holder's option, into a specified number of shares should be separated into a liability component and an equity component. This approach seems reasonable and reflects the economic substance of most convertible debt that consists of a debt host and a written call that, if it were a freestanding instrument, would be classified as equity by the issuer.

In contrast, the implication of the proposed subsequent measurement guidance on convertible debt as outlined in Example 10 of the ED is to preclude accounting at fair value through OCI or amortized cost for all convertible debt. Therefore, all changes in fair value, including those arising from the conversion option would be recorded in net income. We question the conceptual basis of an outcome that results in income statement volatility from the component of convertible debt that is clearly equity in substance and would have been classified as such if it were a freestanding instrument.

Furthermore, the project on instruments with characteristics of equity has established a path to an eventual overhaul of convertible debt accounting. The proposed changes in the ED are inconsistent with the tentative conclusions related to convertible debt in the project on instruments with characteristics of equity. This potentially sets the stage for two disruptive changes to the accounting for convertible debt – once when the proposed changes in the ED are implemented, and then when the proposed changes in the project for instruments with characteristics of equity are implemented.

The objective of paragraph 21(a), as discussed in paragraph BC94 and as implied by IG 26-34, appears to be primarily to identify characteristics inherent to debt instruments and to preclude equity instruments and derivatives from classification as fair value through OCI. With that in mind, the application of paragraph 21(a)(1) to convertible debt in Example 10 seems to be a very narrow interpretation. At least two acceptable alternative interpretations exist, both of which would result in convertible debt meeting the requirements of paragraph 21(a)(1).

Convertible debt can be settled in cash if the embedded conversion option is not exercised or in stock if the conversion option is exercised. If settled in stock, the value transferred in stock could be broken down into the return of the principal and the settlement of the conversion feature. In any event, both scenarios involve the transfer of value from the debtor to the creditor that is at least equal to the principal amount of the debt. This characteristic of convertible debt makes it more akin to debt, rather than equity or a derivative. In our view, the application of the proposed measurement guidance to convertible debt in Example 10 is narrow as it presumes that return of principal can only be through the transfer of cash.

Alternatively, the settlement of convertible debt through the exercise of the options could be viewed in two steps: (a) an amount equal to the principal is returned to the creditor; and (b) the creditor uses that amount to purchase stock of the issuer through the exercise of the call option that it holds.

Both the alternate views above would satisfy the conditions of paragraph 21(a)(1), in our view, and are consistent with the principle that the FASB was trying to establish with paragraph 21.

In line with our response to Question 18, we recommend that the FASB leave the existing framework for liabilities, including convertible debt, unchanged. If the FASB decides to persist

with the proposals for liabilities, we recommend that, at the very least, convertible debt should be eligible for subsequent accounting at fair value through OCI or amortized cost through a specific scope exception from the provisions of paragraph 21(a)(1).

Questions for Preparers and Auditors

Question 28: Do you believe that the proposed criteria for recognizing qualifying changes in fair value in other comprehensive income are operational? If not, why?

No. The ED would allow recognition of a financial asset or liability meeting certain criteria at fair value through other comprehensive income (OCI), if the reporting entity's *business strategy for the financial instrument* were to collect or pay the related contractual cash flows, rather than to sell or settle the financial instrument with a third party. However, an entity typically has a strategy for portfolios of financial assets and/or liabilities and manages those portfolios as a unit, and does not have a strategy for the constituent financial instruments. The portfolio strategy may anticipate that some portion of the portfolio will be sold or settled prior to maturity, but such items cannot be identified at the time the financial instrument is acquired, originated or issued. An amortized cost accounting model is a better representation of the business strategy of holding non-trading financial instruments for collection or payment. While fair value through net income is an appropriate accounting model for trading businesses, fair value either through net income or OCI does not best reflect the activities of a business that is managed for cash flow and liquidity management purposes. For such a non-trading business, fair value does not help a financial statement user to project the business' cash flows, revenues or expenses. As a result, the financial statements would provide a less transparent view of the entity's business operations and its performance.

For these reasons, the IASB's mixed attribute classification and measurement model for financial instruments in IFRS 9, *Financial Instruments*, the Exposure Draft, *Fair Value Option for Financial Liabilities,* and IAS 39, *Financial Instruments: Recognition and Measurement*, while not perfect, is superior to the FASB's proposed classification and measurement model. However, there are aspects of the IASB's classification and measurement model that we do not support relating to not allowing recognition of unrealized gains and losses in net income when they are realized (that is, no "recycling") and to the inconsistent treatment of hybrid assets and hybrid liabilities.

Question 29: Do you believe that measuring financial liabilities at fair value is operational? If not, why?

No. For the most part, financial liabilities other than trading liabilities, derivatives and issued bonds are not readily marketable. Accordingly, the inputs to the models that would be used to estimate fair value would likely be unobservable, leading to a significant expansion of Level 3 liabilities. The ED's requirement to separately measure a CVA component of the fair value of financial liabilities carried at fair value would create operational difficulties. See our comments on CVA in response to Questions 32, 33 and 34. Furthermore, these instruments are generally held until they mature, so the more relevant measure is the par amount or principal balance that represents the potential cash outflow from the entity.

Question 30: Do you believe that the proposed criteria are operational to qualify for measuring a financial liability at amortized cost? If not, why?

Citigroup strongly disagrees with the limiting conditions that a liability would have to meet in order to be eligible for amortized cost accounting under the ED. The proposed conditions would establish an arbitrary bright line based on the measurement attribute of the asset side of the balance sheet (whether 50% or greater of the assets of a segment or a consolidated entity are measured at fair value) to determine whether a financial liability is eligible for amortized cost accounting. Again, the basis for establishing this bright line seems to be the FASB's intent to resolve mismatches between assets and liabilities. We do not understand why that mismatch cannot be resolved within the existing accounting framework for liabilities by a reporting entity's simply availing itself of the fair value option. In practice, financial institutions will not qualify for amortized cost accounting, except perhaps for mortgage debt, because a majority of their assets are financial assets.

Question 31: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is operational? Do you believe that the remeasurement approach is clearly defined? If not, what, if any, additional guidance is needed?

There are significant conceptual uncertainties to be resolved in order to apply the remeasurement approach. Given these uncertainties, the remeasurement approach is not operational. A significant operational burden would be placed on banking entities to implement a remeasurement process and to continuously update the assumptions and calculations supporting the composition of core deposits, blended alternative funds rates, implied maturities and other inputs. Maintaining these analyses will require significant enhancements to information systems and other processes, as well as developing personnel with the requisite expertise needed to derive meaningful results. More importantly, the lack of specific remeasurement guidance will lead to wide differences in interpretation, resulting in entities remeasuring their core deposits very differently. It will therefore be impossible for financial statement users to compare or reconcile two entities' financial statements, as even with detailed disclosure of the methods used it will not be possible for users to estimate the results as if different, more comparable methods had been used.

We acknowledge that remeasurement is not a full assessment of fair value, but it is clear that many of the underlying assumptions in the approach are similar to those considered in the valuation of an acquired core deposit intangible, for which valuation specialists are commonly engaged to assist in the valuation due to a lack of relevant expertise within the banking institution.

To illustrate the complexity in interpreting the remeasurement guidance for core deposits, we provide specific examples as follows:

- Alternative Funds Rate - Inherent in this concept is the assumption that a banking entity without any core deposits available as a "*cheaper source of funding*" would be able to acquire a sufficient amount of replacement funding at a higher rate. This may not necessarily be the case for all institutions. Further, paragraph IG24 requires that "*Management should use judgment in considering sources of funds based on availability*

as well as ***rates that would be available to the entity*** *if such funding was needed*" (emphasis added). This construct requires the prediction of a banking entity's borrowing spread under circumstances that have never been experienced. A bank without deposit capability is an insolvent institution. Therefore, in applying the guidance, a banking entity must not only use the flawed logic that sufficient alternative funding could always be obtained, but also use significant judgment to estimate the (presumably) higher than prevailing rates that would be applicable to such funding.

Ignoring the potential unavailability of replacement funding, the absence of having core deposits must logically result in other available funds becoming scarcer. However, given the level of subjectivity involved, each entity's estimate of the interest rate impact of funds becoming scarcer will be wildly different and a guess at best. Further, even if an entity could reasonably estimate the overall impact on interest rates, further complexity is added by having to estimate the "mix" of more expensive funding that would be attainable to determine a blended rate.

If the Board did not intend for preparers to estimate the impacts of an increased scarcity of funds that would result without core deposits, and wanted preparers to use prevailing rates for the alternate borrowings as if it were normal for a bank not to have core deposits, it is not clear how the results of the remeasurement exercise could be considered meaningful and would further show this calculation to be an academic exercise that produces results of little usefulness.

- Implied maturity – "implied maturity" is contrary to the concept of a core deposit. Implied maturity suggests the life of a balance (i.e., a single financial instrument), while core deposits in reality represent a relatively constant minimum level of liabilities created by the net revolving activity of a pool of deposit accounts.

  Demand deposit accounts are transactional by nature. Depositors not requiring immediate access to funds would likely invest those balances elsewhere. As a result, the life of a particular "balance" is relatively short and should not be adjusted to reflect the tenor of a revolving pool of liabilities.

  At some balance level, core deposits may be considered "evergreen," as the pooled amount of deposits may not have fallen below that level for a significant period of time. It is not clear how to assign a maturity to these balances. The proposed standard refers to the use of an "average life by account type." It is not clear what internal data or peer information should be considered to determine such an average life by account type. Should the average life be based on a specific account balance? Deposited funds are fungible, so it is not possible to track the "life" of a specific balance in an active deposit account. Should the average life be based on the length of time a demand deposit account has been open? Not all accounts consistently have balances and this will result in newly opened accounts immediately cutting in half the life of the longest lived accounts. Additionally, entities may exclude or include closed accounts in this determination, further affecting comparability. Should the average life be based on the length of time closed accounts were previously open? Although this may be the most accurate depiction of the full life of an account, the data could be stale and again not all accounts consistently had balances. If all of the above options would be considered acceptable, vastly different

results would be obtained, rendering those results not comparable, even with the disclosure of a particular method used, as the results of using a different method would not be apparent to financial statement users.

Is it the Board's intention that during an economic downturn or the credit downgrade of a banking entity, when a banking institution will likely see increases in its borrowing spreads, the institution should recognize income to reflect the increasing "value" of its deposits meeting the Board's definition of core deposits? Although the differential between the all-in-cost-to-service and the cost of alternate borrowings may increase, there could be a future decrease in the "implied maturity" of demand deposits, by product that will add yet more subjectivity and complexity to the remeasurement approach and decrease the comparability of financial statements.

- Average core deposit amount – paragraph BC123 states "*The Board believes that core demand deposits should be remeasured equal to the present value of the* ***average core deposit amount*** *discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits*" (emphasis added). It is inappropriate to use an average balance to develop a period-end balance sheet measure. Moreover, without further guidance, there will be significant variation in the determination of the average core deposit amount. Entities could effectively consider activity for a month, a quarter or a year (or longer) and come up with materially different answers. Adding even further subjectivity is the determination of an appropriate discount rate.

- All-in-cost-to-service rate – it is not clear if this entity-specific calculation includes the entire "*expense of maintaining a branch network*" or some allocation thereof that directly relates to core deposits. If it is the former, there is effectively no recognition of the costs related to non-core deposits or the fact that branch networks provide many other services beyond deposit taking, as the remeasurement would require the core deposit liability adjustments to absorb the entirety of such costs. If it is the latter, there may be vastly different results for each entity not only because of the subjectivity inherent in allocating various costs, but also because of the significantly different cost structures of each entity resulting from varying scales of operations, breadth of product lines and other factors that could materially affect the level of costs included in the remeasurement.

  In addition, with a focus on branch network expenses, the concept of the "all-in cost-to-service rate" appears more focused on retail demand deposits and less so on institutional demand deposits, while institutional depositors may provide a significant amount and sometimes a majority of core deposit liabilities. Generally, institutional depositors maintain relationships directly with corporate offices of banking entities and do not utilize branch networks. Institutions maintaining significant demand and other deposit account balances may receive other value from their banking relationships, such as payment processing and other transactional services, M&A support, reduced fees and costs when borrowing from the banking entity, reduced commissions and other benefits. It is clear that these benefits relate at least in part to the demand deposits that may qualify as core deposit liabilities, but it is not clear how these benefits should be factored into the "all-in cost-to-service rate," including identification, valuation and allocation

between the deposits that may qualify and those that do not qualify as core deposit liabilities.

We trust that the foregoing examples demonstrate that remeasurement is not only flawed in concept (i.e., adjusting the carrying value of specific deposit liabilities to reflect a benefit related to the net revolving activity of a pool of deposit accounts), but also inconsistent and incomplete with respect to its stated approach and intended result. The approach lacks a full consideration of various economic realities related to core deposits, including an increased scarcity of funds if core deposits did not exist, probable changes to business models or product pricing if borrowings were more expensive than core deposits and other less specific benefits that may be afforded to institutional and other large depositors.

As another related matter, it is not clear how the proposed guidance will affect existing core deposit intangible assets and the related deposit liabilities. The remeasurement methodology seemingly embeds elements of a core deposit intangible, which is not a financial instrument, into a financial liability. Moreover, to the extent that a purchased core deposit intangible exists, the remeasurement methodology would result in duplicate reporting of the intangible asset. Will there be transition provisions or does the Board intend to continue with the existing, gross, asset-side carrying value model for intangible assets related to acquired core deposits and apply this new "net-presentation" remeasurement model for those that have been originated? Will there be recognition of core deposit intangibles in future purchase transactions? If acquired deposits will not be subject to the remeasurement proposal, it is not clear why the different accounting would be appropriate.

Presentation

Questions for All Respondents
Question 32: For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB's tentative decisions on financial liabilities measured at fair value under the fair value option? Why?

For financial liabilities measured at fair value with all changes in fair value recognized in net income, it is more appropriate to recognize both the changes in an entity's credit standing and changes in the price of credit in OCI. Separating an entity's credit spread into two components representing the price of credit and an entity's specific credit standing is not a meaningful exercise. The FASB explored a similar concept (albeit in the context of hedge accounting) in connection with FAS 133 and DIG Issue No. E1 and discovered that constituents and the marketplace did not evaluate, trade or price credit risk in this bifurcated manner. Thus, paragraph 15 of FAS 138's Basis for Conclusions indicates that credit risk should include both credit sector spread and any credit spread attributable to a specific borrower.

The biggest challenge facing the existing accounting framework for liabilities is the counterintuitive result produced today by the inclusion of an entity's own credit risk in earnings for liabilities designated under the fair value option. That is, gains would be reported in

earnings when the market view of an entity's credit risk increases, as evidenced by a widening of its credit spread, and losses would be reported when the market view of an entity's credit risk diminishes when its credit spread narrows. The FASB's proposals would change the existing framework fundamentally without resolving this critical issue. While proposed disclosures mitigate the issue, a more comprehensive solution would be to exclude the effects of an entity's own credit risk (including both changes in an entity's credit standing and changes in the price of credit) from the total changes in fair value recorded in earnings until those amounts are realized. This would be generally consistent with the IASB's proposal in ED/2010/4 and would result in more meaningful financial statements.

We understand that certain financial statement users believe the change in fair value of a financial liability attributable to a change in an entity's own credit risk (including both changes in an entity's credit standing and changes in the price of credit) is not a meaningful component of fair value because they are not generally realizable. Under FASB's proposals in the ED, financial statement users are no longer provided with information regarding the amount of fair value change that is due to the price of credit. We expect certain financial statement users will object to this loss of information, because they will no longer be able to isolate the full impact on earnings due to changes in the entire amount of own credit risk.

Question 33: Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in the entity's credit standing (excluding the changes in the price of credit). What are the strengths and weaknesses of each method? Would it be appropriate to use either method as long as it was done consistently, or would it be better to use Method 2 for all entities given that some entities are not rated? Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity's credit standing, excluding the price of credit? If so, please explain why those methods would better measure that change.

As noted in our response to Question 32 above, neither Method 1 nor Method 2 is the best method to determine an entity's credit standing. Method 1 relies on ratings and identifying "similar" institutions to allow the reporting entity to separate a "sector" credit from an entity specific credit. Ratings by rating agencies tend to be lagging indicators and thus may not represent a market participant's view of either sector credit or an individual company's credit. Method 2 eliminates the use of ratings, but still requires a company to separate the overall spread above the risk free rate into two elements – one that represents a sector view and the balance that would represent company specific credit. In many circumstances, the entire spread above the risk free rate may not be observable. In all circumstances, the separation required by the Exposure Draft is not observable in the market. It would be another significant management estimate with little basis in market practice. The most appropriate method is to continue to disclose the total credit spread above the risk free rate (i.e., LIBOR, Treasuries) rather than try to identify a portion of the credit spread. This reflects the way the credit markets transact and price credit risk. Additionally, it will result in better comparability through the elimination of a highly subjective judgment.

The ongoing data requirements and changes to computer systems necessary to calculate the change in fair value of a financial liability attributable to a change in the entity's credit standing (excluding changes in the price of credit) pursuant to either Method 1 or Method 2 would be very time consuming and costly. We object to such a significant re-definition of credit risk

without clear justification that this new information is being sought from market participants, risk managers, and other financial statement users.

Question 34: The methods described in Appendix B for determining the change in fair value of a financial liability attributable to a change in an entity's credit standing (excluding the changes in the price of credit) assume that the entity would look to the cost of debt of other entities in its industry to estimate the change in credit standing, excluding the change in the price of credit. Is it appropriate to look to other entities within an entity's industry, or should some other index, such as all entities in the market of a similar size or all entities in the industry of a similar size, be used? If so, please explain why another index would better measure the change in the price of credit.

As noted in our response to Question 33 and Attachment I above, neither proposed method is appropriate. Any separation of an entity's credit spread into the price of credit and a change in the entity's credit standing would be arbitrary. There is no existing index that would facilitate such a separation.

Credit Impairment

Questions for All Respondents
Question 37: Do you believe that the objective of the credit impairment model in this proposed Update is clear? If not, what objective would you propose and why?

The objective of the credit impairment model as stated in paragraph 36, "… to establish a model for recognition and measurement of credit impairment of financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income on the basis of an entity's expectations about the collectability of cash flows, including the determination of cash flows not expected to be collected" is clear.

However, we disagree with the FASB's overall credit impairment model primarily in four respects. First, it would be inappropriate to immediately recognize lifetime credit impairment at origination of a loan or debt security not held in a trading portfolio. The revenue associated with these financial assets is recognized over their lives and the related costs (e.g., credit impairment) should follow a similar pattern. Upfront recognition of all expected losses, without consideration of the future earnings that are intended to support/absorb these costs, is illogical. Second, the recognition of interest income and credit impairments should be separate analyses and should not be commingled. Third, the proposed credit impairment model disregards expectations of future losses, and requires an entity to ignore expectations of future economic trends. Fourth, the proposed model would expand a model with provisions similar to ASC 310-30 (formerly SOP 03-3) that is operationally burdensome to apply.

The FASB's proposed credit impairment model is inappropriate and would be extremely difficult to implement as it mixes together interest income and the allowance for credit losses. Credit and interest rate risks are managed separately and different financial, risk and loan systems are used to monitor them and gather the requisite financial reporting information. Maintaining extensive records for each asset carried at fair value through OCI to determine the effective interest rate, estimate changes in expected cash flows, reflect the resulting additions and reductions to the loss reserve, track the "excess interest" amounts that need to be recorded

in the loss reserve as well as any related loss reserve releases and separately record subsequent recoveries will require an intensive expansion of possibly multiple system requirements. Financial statement users are unlikely to find this mixed presentation of credit losses and interest income useful in analyzing a reporting entity's results of operations. See our comments on *Operational Issues* in the cover letter.

Question 38: The proposed guidance would require an entity to recognize a credit impairment immediately in net income when the entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s).

The IASB Exposure Draft, *Financial Instruments: Amortised Cost and Impairment* (Exposure Draft on impairment), would require an entity to forecast credit losses upon acquisition and allocate a portion of the initially expected credit losses to each reporting period as a reduction in interest income by using the effective interest rate method. Thus, initially expected credit losses would be recorded over the life of the financial asset as a reduction in interest income. If an entity revises its estimate of cash flows, the entity would adjust the carrying amount (amortized cost) of the financial asset and immediately recognize the amount of the adjustment in net income as an impairment gain or loss.

Do you believe that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s) as proposed in this Update, or do you believe that an entity should recognize initially expected credit losses over the life of the financial instrument as a reduction in interest income, as proposed in the IASB Exposure Draft on impairment?

It would be inappropriate to immediately recognize lifetime credit impairment at the origination of a loan or debt security not held in a trading portfolio. The revenue associated with these financial assets is recognized over their lives and the related costs (i.e., credit impairment) should follow a similar pattern. Upfront recognition of all expected losses, without consideration of the future earnings that are intended to support/absorb these costs, is illogical.

While we disagree with the linking of interest income and credit impairment, we concur with the IASB's proposal to allocate a portion of expected credit losses over the life of a financial asset, augmented by immediate recognition of incurred losses. Conceptually speaking, one could view credit impairment as a component of the cost necessary to generate interest revenue, similar to a cost of goods sold expense in a manufacturing environment. Separate presentation of revenues and the related expenses incurred provides important financial relationship details, while commingling the interest income and credit cost lines in a lending environment could obfuscate these details. Moreover, the IASB's loss recognition methodology at origination is conceptually inconsistent with their proposal that subsequent changes in the estimated credit losses should be recognized immediately through a catch-up adjustment.

The Expert Advisory Panel's (EAP) proposals should be seriously considered. This approach is based upon expected loss rather than expected cash flows – thereby decoupling credit losses from interest income – and segregates a loan portfolio into a good book and a bad book (which includes all impaired assets). Reserves for the bad book would be equal to lifetime expected

losses (as determined in accordance with ASC 310-10-35 (formerly FAS 114)), while reserves for the good book would be established through periodic recognition of expected losses over the portfolio's remaining life, augmented by immediate recognition of incurred losses.

The FASB and IASB should work together on a single credit impairment model that will reduce the number of competing models without distinction between assets that are originated and those that are purchased.

Question 39: Do you agree that a credit impairment should not result from a decline in cash flows expected to be collected due to changes in foreign exchange rates, changes in expected prepayments, or changes in a variable interest rate? If not, why?

Yes, we agree that declines in expected cash flows due to changes in foreign exchange rates, expected prepayments and variable interest rates are not credit-related events. Therefore, no credit impairment should be recognized for such events.

Question 40: For a financial asset evaluated in a pool, the proposed guidance does not specify a particular methodology to be applied by individual entities for determining historical loss rates. Should a specific method be prescribed for determining historical loss rates? If yes, what specific method would you recommend and why?

Specifying a particular methodology for determining historical loss rates would not be beneficial. In particular, U.S. banks have externally disclosed historical loss rates in various periodic reports. Such statistics have resulted from long-standing methodologies that, if changed, could yield results that are neither comparable with currently reported amounts nor of incremental use to the readers of these disclosures.

Question 41: Do you agree that if an entity subsequently expects to collect more cash flows than originally expected to be collected for a purchased financial asset, the entity should recognize no immediate gain in net income but should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset? If not, why?

We do not agree. If an entity subsequently expects to collect more cash flows than originally expected to be collected for a purchased financial asset, the entity should recognize an immediate gain in net income. If we must record negative adjustments immediately, then the same should be true for positive adjustments. Furthermore, adjusting the effective interest rate on a quarterly basis for a very large number of assets is not operationally feasible.

Question 42: If a financial asset that is evaluated for impairment on an individual basis has no indicators of being individually impaired, the proposed guidance would require an entity to determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit impairment exists. The amount of the credit impairment, if any, would be measured by applying the historical loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets to the individual financial asset. Do you agree with this requirement? If not, why?

The FASB should clarify the guidance in paragraph 65 of the Exposure Draft.

We understand current guidance (per ASC 310-10-35-15 and 310-10-35-34 to 36 or questions 11 and 12 of the FASB Staff Implementation Guide, Application of FASB Statements 5 and 114 to a loan portfolio) to require a further pooled/statistical [FAS 5] analysis of a loan where it has been identified for individual evaluation, it was determined that the loan is not impaired under FAS 114, and if specific characteristics of the loan indicate that it would be probable that there would be an incurred loss in a group of loans with those characteristics. Where a loan has been determined to be impaired and has been evaluated for impairment under FAS 114, paragraphs 15 and 35 do not permit that loan to be aggregated with other loans with common characteristics and evaluated again for impairment as part of the group. In addition, current guidance in paragraph 34 states that an additional FAS 5 allowance is not permitted even if the individual impairment evaluation results in no allowance as follows, "Double counting by applying this Subsection [FAS 114] and then applying that Subtopic [FAS 5] to measure the same loss again is inappropriate."

It is unclear whether or not the FASB is proposing to amend this guidance and instead require a statistical or pooled calculation to estimate an allowance for credit impairment when an individual assessment leads to the conclusion that a loan is impaired, but no allowance is required (for example, when the loan is collateral dependent and its collateral value is in excess of the loan's carrying value). We believe that such an amendment would overstate the allowance for loan losses (and the losses inherent in the loan portfolio) and suggest that the FASB clarify this paragraph accordingly.

Further clarification of paragraph 65 is also required with respect to the evaluation of debt securities. Currently, securities are commonly evaluated for impairment on an individual basis, with no secondary evaluation required if no impairment is indicated. Although entities may combine identical securities (e.g., those having the same CUSIP) for impairment evaluation, there is no concept of combining securities that have "similar characteristics" for purposes of an impairment evaluation. If the FASB intends this one impairment model apply to all financial assets, the Board should provide examples of the characteristics of debt securities that should be evaluated as being "similar."

Questions for Preparers and Auditors

Question 46: The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectibility of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on Impairment proposes an expected loss approach and would require an entity to estimate credit losses on basis of probability-weighted possible outcomes.

Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting

future events or economic conditions that did not exist at the end of the reporting period would be more appropriate? Are both methods operational? If not, why?

An expected loss approach that would include forecasting future events would be more appropriate and is, in fact, required to determine a financial asset's fair value. It is unrealistic to assume that economic conditions existing at the end of a reporting period would remain unchanged for the remaining life of a financial asset. Accordingly, this aspect of the IASB's proposal is appropriate. However, we oppose the IASB's proposal to use a probability-weighted method to calculate the amount of the expected credit losses, since the operational burden on any institution with a sizeable financial instruments portfolio would be significant.

The ED will require two cash flow analyses – one for credit impairment purposes that assumes no change in current economic conditions and a second one to establish the asset's fair value which will have to incorporate assumptions on future events. As a result, the valuation methodologies for the financial asset and its related credit impairment reserve are inconsistent – the asset is at fair value; however, the loss reserve (by virtue of excluding expectations of future events) is not. This will cause net income and OCI impacts that will be illogical, depending on where one is in the economic cycle (e.g., if economic conditions are expected to deteriorate, OCI will reflect the higher expected losses; net income will not). The ED's approach would increase the pro-cyclicality of the loan loss reserve and result in an understatement of reserves when the economy is entering a downturn.

In addition, the ED's requirement that only historical information and existing conditions may be used to develop estimates of life of asset losses is unworkable and will produce estimated "losses" that do not measure the entity's actual expectations of future losses. Financial statement users will disregard such estimated losses because they are not based on the best information available and are not economically supportable. Accordingly, expectations of future economic trends and conditions should be factored into the impairment calculations. However, if the FASB pursues its current proposed methodology, further clarity on "an entity's expectations about collectibility" would be helpful. For example, if the unemployment rate has dropped for the past two quarters and current manufacturing and economic data as of the balance sheet date indicate that the rate will continue along this trend, would it be acceptable to forecast a future unemployment rate decrease, especially if history shows that these other factors are early indicators of unemployment improvement.

Question 47: The proposed guidance would require that an appropriate historical loss rate (adjusted for existing economic factors and conditions) be determined for each individual pool of similar financial assets. Historical loss rates would reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool. Would such an approach result in a significant change in practice (that is, do historical loss rates typically reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool or some shorter period)?

Historical loss rates are based upon principal losses only, while the ED's premise is that credit impairment encompasses both principal and interest losses. Developing loss rates that would combine both principal and interest cash flows over the life of smaller-balance, homogeneous loans represents a significant change in practice.

Interest Income

Questions for All Respondents

Question 48: The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses.

Do you believe that the recognition of interest income should be affected by the recognition or reversal of credit impairments? If not, why?

No, interest income should not be affected by the recognition or reversal of credit impairments. Interest income recognition should be based on the financial asset's effective interest rate (EIR) applied to the amortized cost balance, rather than amortized cost net of any allowance for credit losses as this provides a more accurate portrayal of the economic yield associated with the asset and is not an area of current GAAP that has been subject to debate or abuse. Effective interest rates are generally calculated on an individual asset basis, while credit loss expectations are often derived on a pool basis. It is not appropriate to treat pool-driven estimates as an adjustment to an individual asset's EIR.

In today's financial statements, interest income is a measurable, relevant disclosure based upon specific contractual cash flows. Under the ED, the reliability of this income statement item would be greatly diminished, since it would no longer be measured by contractual terms and actual cash receipts, but rather, based upon estimated balances subject to quarterly changes in impairment estimates. Therefore, the accounting for the allowance for credit losses should not be commingled with the accounting for interest income, as such commingling would decrease transparency and confuse financial statement users that have a clear understanding of credit losses and interest income under existing GAAP.

Net interest margin is a key statistic monitored by bank analysts. Following the ED's approach would result in a combination of interest income with credit impairment, which would render this statistic meaningless to financial statement users.

Also, the same interest income recognition model should apply to all financial instruments, regardless of whether the instruments are evaluated for impairment on an individual or pool basis, are purchased or originated, or are reported at fair value through net income or OCI.

Companies currently use separate systems for reporting interest income and managing credit risk. Combining these two items would require significant systems development, particularly since they are not managed in concert. Operational requirements to support this proposal would be significant.

Question 49: Do you agree that the difference in the amount of interest contractually due that exceeds interest accrued on the basis of an entity's current estimate of cash flows expected to be collected for financial assets should be recognized as an increase to the allowance for credit losses? If not, why?

No, we do not agree that the difference in the amount of interest contractually due that exceeds interest accrued on the basis of an entity's current estimate of cash flows expected to be collected for financial assets should be recognized as an increase to the allowance for credit losses.

First, the reliability of interest income would be greatly diminished, since it would no longer be measured by contractual terms and actual cash receipts but rather based upon estimated balances that will be subject to quarterly changes in impairment estimates.

Second, this approach would require frequent increases in the allowance for credit losses due to excess interest amounts, which amounts would then be released against the provision for loan losses. This would effectively result in a reclassification of interest income to the provision for loan losses that would be extremely difficult to achieve operationally and would not provide significant benefit to the users of the financial statements.

Question 50: The proposed guidance would permit, but would not require, separate presentation of interest income on the statement of comprehensive income for financial assets measured at fair value with all changes in fair value recognized in net income. If an entity chooses to present separately interest income for those financial assets, the proposed guidance does not specify a particular method for determining the amount of interest income to be recognized on the face of the statement of comprehensive income. Do you believe that the interest income recognition guidance should be the same for all financial assets?

Yes, interest income recognition should be the same for all financial assets and should not change from the current interest recognition method based on contractual interest rate (adjusted for premiums, discounts, origination fees and costs).

Question 51: Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient to understand the proposed credit impairment and interest income models? If not, what additional guidance or examples are needed?

Example 20 in the ED's Implementation Guidance seemingly is using period-end asset and allowance balances to calculate interest income for the entire reporting period. This example needs to be clarified to show how interest income would be determined where the asset cost basis changes during the reporting period (e.g., for an installment, revolving or amortizing asset), while recognizing that credit loss reserves are typically re-evaluated once each quarter. An example should also be created to show how interest income would be determined for assets evaluated for impairment as part of a pool.

Hedge Accounting

Questions for All Respondents

Question 56: Do you believe that modifying the effectiveness threshold from *highly effective* to *reasonably effective* is appropriate? Why or why not?

Yes. We support the FASB's objective of reducing the complexity associated with assessing hedge effectiveness, including a modification of the effectiveness threshold from *highly effective* to *reasonably effective.* Consistent with our 2008 comment letter on the proposed amendment to SFAS 133, qualitatively demonstrating an economic relationship between the hedging instrument and the hedged item at hedge designation is sufficient to support effectiveness and is more consistent with a principles-based approach.

This alleviated burden to establishing hedge effectiveness would eliminate much of the need for shortcut method and critical terms match hedges; thus, we do not object to the FASB's proposal to eliminate these methods. This change also helps address the FASB's concerns about companies using hedge accounting to achieve fair value accounting for items not permitted to be carried at fair value under U.S. GAAP.

However, absent additional guidance on what constitutes "reasonably effective" and in which circumstances quantitative support would be required to assess an existing hedge relationship, we expect challenges similar to those experienced with the original issuance of SFAS 133. Accounting firms and regulators formulated rules for effectiveness testing independently and outside of the public forum, making consistent and informed implementation and application by preparers difficult.

The FASB should provide illustrative guidance in the final standard to assist companies in determining whether a hedge is *reasonably effective* and when qualitative evaluation of effectiveness is sufficient.

Question 57: Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?

Under the existing long-haul method of effectiveness testing, certain changes in market factors after the inception of a hedge relationship, such as changes in interest rates or credit spreads, can cause a hedge to become ineffective in certain periods and require dedesignation, even though the economic relationship still exists and the hedge is still achieving the desired risk management objective. The proposal's modified effectiveness threshold will alleviate these period-to-period anomalies.

For reasons outlined in our response to Question 56, demonstrating an economic relationship between the hedging instrument and the hedged item at the inception of the hedge relationship is sufficient to support effectiveness and the application of hedge accounting. Absent a contractual or other fundamental change to the hedging instrument or hedged position which could result in there no longer being an economic relationship, the company's original risk management objective is unaffected and hedge accounting should continue without any further effectiveness evaluation.

We recommend that the FASB clarify that reassessment of effectiveness is required only when the underlying economic relationship of the hedged item and hedging instrument changes during the life of the hedge.

Question 58: Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?

It depends. A qualitative approach that does not incorporate the bright line tests of 80-125% effectiveness will likely result in more relationships continuing to qualify for hedge accounting. So long as a hedge relationship continues to demonstrate that it is reasonably effective over the life of the hedge, we expect that period-to-period anomalies in valuation will cause fewer discontinuations of hedge relationships.

However, absent additional guidance on what constitutes "reasonably effective" to better understand when post-designation effectiveness evaluations would be required, we can only presume that the requirement will be less onerous than current practice, which requires a quantitative effectiveness evaluation at a minimum of every three months.

Although we presume the guidance will potentially allow less frequent effectiveness evaluations, without additional guidance, we expect that accounting firms and regulators will formulate rules for effectiveness that may result in an application of bright line tests similar to the current 80-125% effectiveness test. In that case, it cannot be known whether we can expect to see a change in the number of times hedging relationships are discontinued.

Questions for Users

Question 59: Do you believe that a hedge accounting model that recognizes in net income changes in the fair value and changes in the cash flows of the risk being hedged along with changes in fair value of the hedging instrument provides decision-useful information? If yes, how would that information be used? If not, why?

Yes. Aligning the income statement measurement of the hedging instrument and the hedged item provides decision useful information.

Question 60: Do you believe that the proposed changes to the hedge accounting model will provide more transparent and consistent information about hedging activities? If yes, why and how would you use the information provided? If not, what changes do you disagree with and why?

We are generally supportive of reducing complexity in the application of hedge accounting. Hedge accounting results in a financial statement presentation that best reflects the reporting company's risk management approach. Changes to the model that reduce complexity will ease the burden of applying hedge accounting, encouraging reporting companies to use hedge accounting and better aligning the reporting companies' risk management practices and financial reporting.

Questions for Preparers and Auditors

Question 61: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for cash flow hedging relationships? If yes, what constraints do you foresee and how would you alleviate them?

We expect some level of operational burden associated with the change in calculating ineffectiveness for cash flow hedge relationships. However, more significantly, we have conceptual concerns about recording ineffectiveness in situations where the present value of the expected future cash flows of the hedged item exceed those of the hedging derivative (i.e., an underhedge). The FASB should continue with the existing practice of recording ineffectiveness only in situations where the present value of the expected future cash flows of the hedging derivative exceed those of the hedged item (i.e., an overhedge).

Consistent with the FASB's concerns, as laid out in paragraphs 379 and 380 of SFAS 133's basis for conclusions, recording ineffectiveness in an underhedge situation defers a nonexistent derivative gain or loss in other comprehensive income and an offsetting nonexistent loss or gain in earnings (effectively the cost of not executing the "perfect" hedge). The FASB's ineffectiveness proposal obscures the economic effects of the actual hedging relationship in place and we recommend retention of the current approach.

Question 62: Do you foresee any significant operational concerns or constraints in creating processes that will determine when changes in circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness at each reporting period? If yes, what constraints do you foresee and how would you alleviate them?

As outlined above, demonstrating a qualitative economic relationship between the hedged item and the hedging instrument at designation (e.g., that both items are sensitive to changes in interest rates or a particular currency) should be sufficient to support an assertion of ongoing effectiveness. We do not expect verification of said economic relationship to be burdensome on a quarterly basis provided that it entails verification that there has been no change in the critical terms of the hedged item or hedging instruments that supported the original conclusion.

As outlined above, we recommend that the FASB clarify that reassessment of effectiveness is required only when the critical terms of the hedged item or hedging instruments change during the life of the hedge. Absent clarification from the FASB of the relaxed assessment burden, we expect the accounting firms and regulators to formulate implementation rules for effectiveness and expect that there will be a burden equivalent to what is experienced under the current model.

Question 63: Do you foresee any significant operational concerns or constraints arising from the inability to discontinue fair value hedge accounting or cash flow hedge accounting by simply dedesignating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?

Yes. Requiring the effective termination of the hedging instrument by entering into offsetting derivatives increases execution cost, increases credit risk, and adds complexity to the hedge accounting model, all of which appear contrary to the FASB's overall objective for this project.

A non-zero value derivative with the same counterparty will generally be required to offset the effect of a hedging instrument. We question whether the FASB fully contemplated this requirement, as it presents a significant operational constraint, as well as an untenable market condition with respect to counterparties knowing they are the primary, and perhaps the only,

source for an entity to obtain an offsetting derivative (as a derivative executed with another counterparty may be subject to different credit risk and may not be seen as offsetting to the first derivative).

Dedesignation and redesignation of hedge relationships reflect the dynamic nature of hedging as a risk management practice. In the basis for conclusions, the FASB indicates that "because the economics of the relationship between the hedging instrument and the hedged item have not changed, the Board believes that the accounting should not change." As we described in our 2008 comment letter, this statement may not be true for relationships with a hedged item that incorporates optionality. Changes in prepayment assumptions in a mortgage loan can alter the relationship with the hedging instrument. Even in cases where the relationship between the hedging instrument and the hedged item hasn't changed, the hedge relationship can change in the context of the company's overall financial position and risk management objectives. Given that a company's financial position is dynamic, its risk management practices will be dynamic; hedge accounting should permit dedesignation and redesignation in order to reflect this economic reality.

We are also concerned with how this provision will impact common hedge strategies, namely net investment hedges and hedges of forecasted foreign currency receivables and payables. We often hedge our net investments in foreign currency functional subsidiaries with foreign-currency-denominated debt. If dedesignation were to require termination of the hedging instrument or execution of an offsetting position, it is unclear how this would be executed in this scenario.

This guidance will also impact hedging relationships in which the designated risk being hedged is the forecasted settlement of a foreign currency receivable/payable to be incurred in the future. For example, foreign currency hedgers routinely dedesignate cash flow hedges of a forecasted settlement of a foreign currency receivable/payable to be incurred in the future at the time the underlying revenue/expense is recorded. From the date of dedesignation, the hedge is marked to market through earnings and the mark-to-market offsets the remeasurement of the foreign currency receivable/payable through settlement.

We are not aware of any current major practice issues, complexities or abuses related to dedesignations and redesignations of existing hedges. Further, because management is required to document its intent to designate or dedesignate contemporaneously, we fail to understand how designation or dedesignation could be considered an earnings management tool. The complexity and operational constraints associated with this proposal are fully eliminated by continuing to permit dedesignation. Additionally, given the overall requirement of this proposed standard whereby virtually all financial instruments will be marked to market regardless of whether or not they are part of a hedging relationship, it is not clear why the ability to voluntarily dedesignate a hedge is of concern.

Question 64: Do you foresee any significant operational concerns or constraints arising from the required concurrent documentation of the effective termination of a hedging derivative attributable to the entity's entering into an offsetting derivative instrument? If yes, what constraints do you foresee and how would you alleviate them?

As outlined above, our primary concern is requiring effective termination via an offsetting derivative to effect a dedesignation of a hedging relationship. Requiring documentation of the effective termination poses no different/additional burden than current requirements.

Disclosures

Question for All Respondents
Question 65: Do you agree with the proposed disclosure requirements? If not, which disclosure requirement do you believe should not be required and why?

Paragraph 102(b) would require that the amortized cost, allowance for credit losses and weighted average interest rate be disclosed for *each* pool. For a financial institution, the number of pools could be considerable. This requirement is excessive; aggregated information should be permitted for pooled assets.

Paragraph 109 would require a sensitivity analysis to reflect the uncertainty in the fair value measurements for Level 3 financial instruments, except for investments in unquoted equity instruments. By definition, Level 3 fair value measurements have inherent uncertainty, which we believe is well understood by users. Stressing the significant unobservable inputs to determine the impact that changes in the inputs could have on the fair values of Level 3 instruments would not provide useful information to users, but would add greater uncertainty to an already uncertain measurement.

Effective Date and Transition

Questions for All Respondents
Question 68: Do you agree with the transition provision in this proposed Update? If not, why?

A cumulative effect adjustment is the appropriate method of transition for the proposed standard. Retrospective implementation at the transition date would be exceedingly burdensome. However, the transition provisions need to be clarified. Cumulative effect adjustments should appropriately be recorded in both retained earnings and in accumulated OCI. The ED only states that a cumulative-effect adjustment to the statement of financial position would be required. In addition, in setting the effective date, the Board needs to take into account that at the initial adoption date, the ED would require the previous year-end's statement of financial position to be restated.

Question 69: Do you agree with the proposed delayed effective date for certain aspects of the proposed guidance for nonpublic entities with less than $1 billion in total consolidated assets? If not, why?

No. We note that a significant proportion of all public companies, including the vast majority of financial institutions, would be provided with an additional four years to implement the standard. We do not understand how this staggered implementation would provide users with comparable financial information across financial institutions in this intervening period and, thus, would not fulfill one of the Board's stated objectives for a lengthy period.

Questions for Preparers and Auditors

Question 70: How much time do you believe is needed to implement the proposed guidance?

If the proposals in this Exposure Draft are adopted as drafted, two years will be an insufficient amount of time to create, test and implement all the new finance, risk and reporting systems that will be necessary to comply with the ED's complex provisions for classification, measurement and impairment. Any new impairment model would require at least three years to implement in practice because of significant required changes to information systems and accumulating new historical loss and other data, and at least four years would be required overall.

Question 71: Do you believe the proposed transition provision is operational? If not, why?

The ED would require that, for the year-end preceding the year of adoption, the standard be applied by means of a cumulative effect adjustment to the prior year's statement of financial position. While a cumulative effect is typically recognized as an adjustment to retained earnings, it would be appropriate to recognize the cumulative impact of the adoption for financial assets and liabilities that will be reported at fair value through OCI in accumulated OCI and not in retained earnings. The Board should clarify the proposed transition provisions to be more specific about which accounts should reflect the cumulative effects of the standard's initial impact.