

September 30, 2010

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Submitted via email to the FASB

# Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

We are pleased to provide our comments on the exposure draft Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (ED).

The ED proposes a complete overhaul to the recognition and measurement criteria for financial instruments and therefore will have devastating implications to the financial reporting process and product. While we have historically supported fair value as a measurement attribute only for certain financial instruments such as trading positions in active markets, however, we believe that in all other cases the use of fair value does not achieve two principles which underscore financial reporting, faithful representation and usefulness. We disagree with the tentative decision to diverge from a mixed measurement model in a move towards full fair value and challenge whether there is sufficient justification for such divergence, as the topic of financial instruments is part of the FASB and IASB's joint project initiatives under the Boards' Memorandum of Understanding.

Moreover, the Update does not properly address the inappropriateness of fair valuing illiquid instruments. The classification model must take into account the uncertainty related to illiquid instrument in the definition of the fair value through net income in order to avoid recognizing in the net income fair value gains or losses, which are not realizable in the short term.

The change in fair value of the banking book may in certain circumstances of stress on markets (for example during Q4 2008) and undue widening of credit spreads create large unjustified reductions of the bank's equity, which may create distrust on banks and exacerbate panic amongst depositors and market, hence bringing about unnecessary financial instability.

Classification and Measurement

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We are against having an overall single principle of measuring all instruments at fair value. We believe that a mixed measurement methodology is the most appropriate for financial reporting, reflecting the actual realities of business. Allowing for a mixed measurement methodology does not create an overly complex approach to reflecting an already complex business. Therefore, complexity is not the primary reason that there needs to be a change, as business models are complex. Using only fair value as a measurement principle misrepresents many aspects of business and therefore misleads users of financial statements.

For debt instruments which have relatively basic cash flow characteristics and which are held for the purpose of collecting (or paying) the instruments' contractual cash flows (versus the realization of interim gains or losses through sales or settlements), we believe that the amortized cost measurement attribute provides the most decision-useful information. The proposed requirement to measure these instruments at fair value, which are intended to be held to maturity, will introduce significant additional operational complexity that carries a cost, which has not been adequately justified. Therefore, if an entity has a business strategy of collecting or paying the contractual cash flows associated with instruments such as loans, finance receivables, and issued debt, then the use of amortized cost should be required.

We do not support a recognition model, which generally requires an entity's own debt to be measured at fair value and believe that the conditions for measuring such liabilities at amortized cost are arbitrary and introduce a new set of bright lines into GAAP and conflict with the economic objectives of how these instruments are managed. The proposed requirement to measure an entity's own debt at fair value (either through other comprehensive income or net income) exacerbates the counterintuitive results arising from including changes in an entity's own credit risk in the fair value of a liability which we observed during the recent credit crisis for entities that elected to carry their own debt at fair value. We believe that reporting counterintuitive results for a significantly larger population of financial instruments will not improve the usefulness of an entity's financial statements.

As we are against the requirement of fair value measurement for all financial instruments, the Update should allow for preparer judgment in determining the potential significance an embedded derivative feature has on the fair value of the instrument. Preparers should have the option either to bifurcate embedded derivatives from hybrid financial instruments or carry them in their entirety at fair value with changes in net income.

#### Credit Impairment

We do not agree with the Update's proposed impairment model, which takes the entire expected loss to the profit and loss account at inception, which results in a day one loss. This completely misrepresents the economics of the transaction.

We support an expected loss approach impairment model based on the following main



# principles:

- Expected losses should be the best estimates of the most likely losses to be experienced on the financial assets existing in the performing portfolio at the balance sheet date;
- The impairment methodology should be based on the expected loss over the life of the portfolio and this impairment should be amortized over the life of the portfolio with a partial catch-up for the prior periods if there is any subsequent changes in estimates;
- The impairment model should be primarily developed for application in an open portfolio context;
- The current definition of amortized cost and the current Effective Interest Rate (EIR) calculation of IAS 39 should not be changed;
- Expected loss allowances are built up to be used and should not be kept as buffers and
- Impaired loans should be treated as in the current IAS 39

The expected loss rate should be amortized over the average life of the portfolio, which would result in a portfolio provision. Each portfolio would then have a specific provision assigned to it, against which all losses from that portfolio would be taken against that provision.

Losses, including related subsequent increases or decreases, are taken to the portfolio provision, at the point when it is determined that part of the contractual cash flows of a particular loan will not be collected. Portfolio provisions are established to be used and therefore are not just buffers with a built-in floor. If the expected loss provision decreases to zero, then any additional losses are taken to the income statement, as the provision can never be negative.

Expected loss rates should be reviewed each period. Any subsequent changes in the expected loss rate would be applied as a new rate for future calculations. A partial catch-up should be booked in the current period that reflects the time period that has already passed. This allows the financial statements to reflect the balance that would have been achieved if the new rate had been used since the origination of the instruments. We do not agree with the ED proposal that any changes in the expected loss rate would result in an immediate booking of the entire changed effect in the current period.

# Hedge Accounting

Although preparer concerns regarding the consequences of unintentionally misapplying the two methodologies (e.g. with corresponding or attendant risk of financial reporting restatement) will be addressed by the elimination of the shortcut method and the critical terms matching criteria, new concerns and practice issues will likely arise such as the ability for companies to operationally comply with the "long haul" calculations prescribed in the



Update. We have suggested below some changes to the ED would eliminate these concerns.

The ED should expand the current bifurcation-by-risk approach population to allow hedges of other identifiable and reliably measurable/observable interest rate risk exposures such as the Federal Funds Rate, the Prime Rate, inflation indexes, etc. This would ease preparers' concerns with performing the complex "long haul" calculations and would achieve convergence with a current IASB decisions.

We completely disagree with the proposed change to prohibit voluntarily dedesignation of a hedge accounting relationship found in the Update. In addition we believe that the proposed guidance on effective terminations to be nonoperational and cost prohibitive. Companies commonly add new hedging relationships and remove, or dedesignate, existing hedge relationships, as changes occur in the risk profile of the hedged risk exposure. As a result, we find the FASB's basis for conclusions regarding dedesignation to be flawed and inaccurate, as such risk management strategies are prudent and appropriate. We do not understand how an earnings recognition-based intent could ever be realized through a decision to dedesignate, as hedge accounting designations must be made in advance of market movements.

Although the ED would allow more hedges to qualify for hedge accounting and relax certain current demands to qualify for hedge accounting, some valid and effective hedges would result in significant income statement volatility without the ability to define the hedged risk associated with a nonfinancial contract in a manner which reflects the economic risk being hedged (e.g. NYMEX crude oil component of a supply contract). The IASB board has recently decided that a contractually specified nonfinancial risk component is a permitted hedged risk, therefore we believe that the FASB should incorporate the IASB's final decisions into its final standard, while also achieving the convergence goal.

Companies most often manage on a portfolio or macro basis their exposure to interest rate risk in both their investment portfolios and liabilities. Contrary to how companies are managed, current US GAAP prohibits entities to designate the combination of financial instruments as a single hedged item unless those individual instruments are expected to respond similarly to changes in the hedged risk. It also prohibits aggregating a combination of financial assets and financial liabilities to be a hedged item. This requires companies who are looking to hedge their net interest rate risk exposure to define the hedged item as either an individual asset or liability, or groups of similar assets or liabilities, which often requires frequent dedesignation/redesignation of the hedge relationship as the net risk exposure within the portfolio changes.

At recent board meetings, as part of its hedge accounting project, the IASB has decided to expand the existing macro hedging approach in IAS 39 by changing how the hedged item can be defined in a macro hedge. The decisions of the IASB would permit the hedged item to



include a net exposure comprised of financial assets and liabilities and derivatives which will ease the burden associated with hedging a company's net interest rate exposure. While the FASB has not formally deliberated the merits of "macro hedging" under its Financial Instruments project, the FASB should consider incorporating the current IASB decisions in this area for inclusion in the final standard on hedge accounting, again achieving another major area of convergence, all while improving the accounting standards on hedge accounting.

### Convergence

We are concerned that the IASB and FASB have proposed very different models for accounting for financial instruments. A common approach is critical to the ability to reconcile the two accounting frameworks and thus to continue progress towards a single set of accounting standards. We urge the boards to work closely to remove any differences in the final standard.

You will find enclosed detailed answers to the questions asked within the exposure draft. Should you have any questions regarding our comments, please do not hesitate to contact us.

Sincerely,

Gerard Gil Deputy CFO



#### 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?

No comment.

**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 believe loan commitments should not be fair valued, except for those related to loans that are traded.

**Question 3:** The proposed guidance would require deposit-type and investment contracts of insurance and other entities to be measured at fair value. Do you agree that deposit-type and investment contracts should be included in the scope? If not, why?

Deposit-type and investment contracts of insurance and other entities should not be required to be measured at fair value. The fair value measurement is an appropriate measurement basis only when the instruments are managed based on their value and when this value is realizable (e.g. trading activities). These types of instruments are generally not trading instruments and therefore should not be measured at fair value.

**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?

No, we do not agree with the proposed change to the criteria for equity method of accounting. The proposed changes to how equity investments need to be accounted for would unnecessarily complicate the accounting for all investments in private companies that do not qualify for the equity method because the information needed to reliably estimate fair value for each reporting period is often not readably available. In addition, most of the investments are made for strategic purposes. This could be the case for entering new markets, gaining access to new technologies, creating new relationships or many other reasons. Therefore, the investee's operations might not always be directly related to the consolidated business. For these reasons, the proposal in the ED would decrease the usefulness and reliability of the financial statements for investors.

Initial Measurement
Questions for All Respondents

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



Yes, we agree with the initial measurement principles for financial instruments.

**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?

Yes, for financial instruments which are not subsequently fair valued through the profit and loss account, we agree that if there is a significant difference between the transaction price and the fair value on the transaction date, it should be recognized in net income if the significant difference relates to something other than fees or costs. If the difference results from the fact that the market in which the transaction occurs is different from the market in which the reporting entity would transact, this should not be recognized, since the related item is not subsequently fair valued through the profit and loss account.

**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 response to question 8.

**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?

1. Instruments that are measured at fair value should expense immediately transaction fees and costs. 2. Instruments that held for the purpose of the yield of the instrument should be at amortized cost and the transaction fees and incremental costs should be deferred and amortized as an adjustment of the yield for that instrument.

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?

See our response to question 9.

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?

No. Fair value measurement should not be defined as a measurement basis by default. There should be multiple measurement principles. For instruments that are managed with the objective of collecting cash flows through their use (cash flow business model i.e. Banking Book for a bank) the most relevant measurement basis is the amortized cost. It is indeed the most relevant approach to present the cash flows that are received by the entity through the use of the assets.

This is the only measurement basis that provides the users of financial statements with a view on the cash inflows in the entity and hence enables the users to estimate the beneficiary capacity of the entity. Indeed, it is the only measurement basis that has predictive value, because it allows analysts and users to develop their estimates.

Gains from the changes in fair value should not be recognized in the profit and loss if they are not realizable by the entity. This results in restricting the use of fair value through the profit and loss to instruments held in a trading business model and traded on an active market, i.e. either i) the instrument itself is traded on an active market or ii) the risks of the instrument can be hedged with instruments that are traded on an active market.

Most of our commercial banking loans have individualized payment terms, collateralization, and guarantee structures, all having no reliable market in which they could be sold, further calling into questions the reliability of using fair value as the basis for financial statements. Even if there were active markets, fair value is not the appropriate measurement for these loans since it does not represent the cash the bank will receive. If a borrower is having problems repaying the loan, our typical process is to work the problem out with the borrower rather than sell the loan. Therefore, even if it were easy to find a market value, that market value is irrelevant, since we would not sell the loan.

#### **Business Model:**

The business model in which the instrument is managed should be the predominant criteria to determine which measurement basis is applicable.

Each business activity has an economic logic, specific to that activity. Different business activities have different business models, each based on a different economic logic. The value of a resource to an activity depends on the way it contributes to net cash inflows, in the context of the economic logic of the activity in progress (i.e. depending on its function and use). A more informative indicator for an investor is the income statement, provided that it reflects expectations about changes in an entity's cash flows and forecasts the entity's long



term capacity to generate profit under a given business model. Although the value of the balance sheet may interest an investor, it is of lesser importance to the extent that it is not representative of how the entity actually uses its resources.

Whether it is through its use, or in conjunction with other assets and liabilities, an asset can produce benefits in different ways. To simplify, an asset's contribution to net cash inflows can be broken down into two basic forms of logic: contribution by its use and contribution by its exchange. Contribution by its use refers to an economic logic in which an asset's value is derived through the use of a resource and any additional inputs. Conversely, when a resource contributes to net cash inflows by its exchange, the cash flow contribution under this model is achieved by giving up the resource.

Because an item can be used in those different ways, financial reporting must recognize the differences inherent in those business models and reflect them in the financial statements.

For the instruments that are managed with the objective of collecting cash flows through their use (cash flow business model i.e. Banking Book for a bank) the most relevant measurement basis is the amortized cost. It is indeed the most relevant approach to present the cash flows that are received by the entity through the use of the assets.

We therefore believe that the classification of one instrument in one or the other business models should follow a positive approach between the cash flow business model if the instrument is expected to contribute to the net cash inflow by its use and the trading book if the instrument is expected to contribute to the net cash inflow by its exchange.

There is a very clear difference between the two kinds of activities of a bank. They follow different management practices and different prudential rules and they are easily identifiable by management and auditors.

Because the business model is built on the realization of the value it creates, financial reporting should follow this criteria to avoid the recognition of unsubstantiated profit and loss. The classification in a business model should therefore be dependent upon the capacity of the entity to use the instrument in the business model in which the entity intends to use it.

The business model criteria should also provide an appropriate reporting framework adapted to the various financial activities that use financial instruments (insurance, corporate treasury departments, fund managers...). For example:

 Financial instruments that must be held by insurance companies to comply with contractual or regulatory commitments with a third party which are required to be settled and measured on the liability side of the balance sheet at the fair value of the underlying financial instruments, should be recognized at fair value through profit and



loss.

Banking and corporate institutions may hold portfolios of debt instruments to realize
their value by their exchange to meet their liquidity needs. However, this activity is
not comparable with the trading business model of financial institutions and therefore,
those portfolios should be measured at fair value through OCI with recycling from a
sale or in the case of impairment.

**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?

These items should be accounted for using amortized cost under the existing requirements. In the balance sheet, the amortized cost would then only be presented, as it would not be appropriate to state the fair value of these instruments in any other place besides the footnotes if needed, since this would just add confusion and irrelevance to the balance sheet.

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

Yes, the subsequent measurement principles should be the same for financial assets and financial liabilities. As previously stated, these should follow the business model for those instruments.

**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?

Because we believe the business model should be the primary criteria to define the appropriate measurement basis for the accounting of financial instruments, we believe that accounting standards should recognize the change of the business model for a particular instrument and should therefore require the change from one accounting category to another with appropriate disclosure.

**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-incost-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?

No. The fair value measurement is an appropriate measurement basis only when the
instruments are managed based on their value and when this value is realizable (e.g.
trading activities). This instrument is generally not a trading instrument and therefore
should not be measured at fair value. In addition, we completely agree with the



- alternative views: The proposal introduces a new measurement attribute for core deposits that would introduce a new element of complexity.
- The scope of the Update is for financial instruments and does not include intangibles.
   Therefore, the Update should not try to value the deposit intangibles outside of considering similar intangibles.
- Deposits should be recorded in the balance sheet at the amount withdrawable on demand.

**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?

We believe that financial liabilities that are not actively traded should be at amortized cost. There may be a few cases where there is an accounting mismatch and in this case, it should be possible to have a revocable option to adopt a measurement basis that aligns the asset and liability to best reflect the connection between these two instruments.

**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?

Yes, it is misleading to record an instrument at fair value when the market value cannot be realized. This is the case for instruments that are non-negotiable due to regulatory features as well as instruments that have no liquid market.

**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?

An entity should evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at amortized cost, in combination with other deferred tax assets.

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?

No. We believe convertible debt should be bifurcated into a liability component, subsequently accounted for at amortized cost, and an equity component.



#### 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?

Recognizing qualifying changes in fair value in other comprehensive income is only appropriate for items measured at fair value and not amortized cost. If a financial instrument is measured using amortized cost, then there should be no recording of any change in the fair value.

In some specific situations, there is rationale to measure financial instruments at fair value through OCI.

Examples of those situations are:

- The entity operates a trading business model with instruments that are not traded on an active market or the risks of which cannot be hedged with liquid instruments; because of their illiquidity, the instruments are not readily convertible to cash.
- The instrument cannot be managed in a cash flow business model. It is for example the case of some non-trading financial instruments with particular optional features (e.g. purchased debt instrument that are convertible into equity instruments of the issuer).

However, because for those instruments the entity may be exposed to a loss on disposal or through their future cash flows, they should be impaired to their fair value when this value is lower than cost. In addition, instruments should never be prohibited from being recycled to the profit and loss statement.

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

For financial liabilities that are activity traded it could be possible to measure the fair value, although the own credit portion should not be considered in fair value changes, as this should be frozen on day one.

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

Measuring a financial liability at amortized cost as it is done under current standards is operational. Adding a fair value component into the measurement is not appropriate. If the business model of the entity is to actively trade the liability, then the instrument should no longer be measured at amortized cost, but at fair value through the profit and loss, which would be in line with its business model.

**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-incost-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?

No. The fair value measurement is an appropriate measurement basis only when the instruments are managed based on their value and when this value is realizable (e.g. trading activities). These types of instruments are not trading instruments and therefore should not be measured at fair value.

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?

We fully support the frozen credit spread approach for liabilities designated at fair value as well as those held for trading. Unrealized fair value changes in own credit risk should not be recognized in gains and losses whatever the accounting category may be.

First, because we believe that gains and losses on liability instrument may be realized only in rare cases. The cases where an entity buys back a liability at a price that reflects the change in its own credit risk and makes a profit are seldom. In such cases, a gain or loss should be reported in the income statement. Second, we believe that the effect in the income statement of that change in fair value is counterintuitive, misunderstood by the users and leads to mismanagement.

For instance, although it might be appropriate in some instances to classify a liability in the Held For Trading category, there is no economic rationale to do so with an objective of trading its own credit spread. In such a case, economic hedges are difficult if not impossible (impossible to write a CDS on your own credit spread, as writing a default protection on yourself is impossible since you would be unable to payoff the CDS should you default) and it would be virtually impossible to define appropriate risk management tools such as sensitivity limits or Var for example. In addition, to our knowledge no banking supervisor has validated a Var model on own credit risk.

Profit and loss should remain the main indicator of performance and it should therefore not be polluted by gains and losses that will likely not be realized in the normal course of business of the entity. It leads to a biased view of the profit and loss and more widely of the performance of the entity.

If own credit were to be reported in OCI, then the gain or loss on derecognition of the



liability should be recycled to profit or loss. While there may not be an expectation that a liability designated at fair value will be repurchased, if it happens then the gain or loss will have been realized and there would appear to be no conceptual reason why it should not be reported in profit or loss. It would be inconsistent and counterintuitive for the gain or loss on derecognition of a liability recorded at amortized cost to be recorded in profit or loss but not the same gain or loss just because the liability has been designated at fair value through profit or loss.

**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.

See response to question 32.

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.

See response to question 32.

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 should state clearly that loan interest income includes a risk premium for expected losses over the life of the loan and these should be recognized accordingly. The restriction to include only past events and existing conditions and no potential future event is in our view theoretical and not operational.

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?



We do not 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, which would result in an inappropriate day one loss. Nor do we 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.

# Distinction between EIR and Expected loss

The calculations of the effective interest rate (EIR) and the expected loss (EL) are proposed by the IASB to be performed on an individual instrument level; in reality, the EIR is calculated on an individual level and the EL is calculated on a portfolio level. This comingling of the expected credit loss into the contractual terms based EIR calculation results in a number that is dependent on the need to precisely identify the period during which these losses will occur, resulting in misleading numbers being produced, as these estimates are impossible to predict. Instead, the model should use the current definition of amortized cost and the EIR calculation. The current EIR calculation and expected loss rate should be separate in their calculations and their reporting in the income statement. We believe decoupling the interest rate from the expected loss information would have a number of advantages, in that it would:

- o provide more transparent and understandable information for users;
- o align more closely with management's approach to credit risk;
- o avoid unit of account issues between expected losses calculated on a portfolio basis and EIR calculated on a loan basis; and
- o be more feasibly operational, and so might reduce the timeline required for the implementation of the proposals.

## Notion of portfolios

The IASB's inability to work on an open portfolio means that the model does not reflect the way the instruments are actually managed, as expected losses are determined at a portfolio level. The definition of portfolios for determining expected losses should be aligned with the credit risk management practices of the reporting entity.

The approach must allow for the use of open portfolios, which are dynamic in the sense that existing loans mature and new loans may be added. This is in order to align the proposed impairment model with internal risk management practices. It would be inappropriate for an impairment model to require only closed portfolios, meaning those which contain only assets of a specific origination and maturity date, because this would result in a very large number of closed portfolios and, in most cases, a disconnection with internal credit risk management.



#### Definition of EL

The model should be based on expected losses, not expected cash flows. Applying an expected loss rate would result in more dependable numbers than trying to estimate the exact timing of cash flows.

The expected loss rate should be calculated using information relating to past events and existing conditions and their implications for the collectibility of the cash flows attributable at the date of the financial statements. In order to achieve the best estimates possible for a future expected loss, entities should use all historical experience that they have, which should incorporate at least one complete economic cycle, related to the products in the current portfolios. Entities that do not have historical loss information may use peer group experience for comparable portfolios. This helps ensure the use of a solid expected loss rate for the same consistent portfolio, which results in proper long-term financial reporting, without inappropriately speculating using point-in-time estimates. Point-in-time estimates should not be used, as no one has knowledge of where they are in an economic cycle, which has been demonstrated time and time again through each downturn and on the contrary should use an expected loss rate that is irrespective of the current position of the economic cycle.

The expected loss rate should be amortized over the average life of the portfolio, which would result in a portfolio provision. Each portfolio would then have a specific provision assigned to it, against which all losses from that portfolio would be taken against that provision.

Losses, including related subsequent increases or decreases, are taken to the portfolio provision, following the current incurred loss methodology. Portfolio provisions are established to be used and therefore are not just buffers with a built-in floor. If the expected loss provision decreases to zero, then the loss is taken to the income statement, as the provision can never be negative.

#### Catch-up adjustment treatment

Expected loss rates should be reviewed each period. Any subsequent changes in the expected loss rate would be applied as a new rate for current and future calculations. A partial catchup should be booked in the current period that reflects the time period that has already passed. This allows the financial statements to reflect the balance that would have been achieved if the new rate had been used since the origination of the instruments. We do not agree with the ED proposal that any changes in the expected loss rate would result in a full catch-up booked entirely in the current period.

**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, 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.

**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?

No, a specific method should not be prescribed for determining historical loss rates. Historical loss rates should be consistent with the way the entity manages its credit risk. A detailed prescription would not be helpful, as the standards should be principle based.

**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?

If an entity subsequently expects to collect more cash flows than originally expected to be collected, the entity should recognize a partial gain related to prior periods in net income and adjust the effective interest rate so that the additional cash flows going forward are recognized as an increase in interest income over the remaining life of the financial asset.

**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 definition of portfolios for determining expected losses should be aligned with the credit risk management practices of the reporting entity. This would mean that it would be permitted to assess the instruments within the context of an open portfolio, at an aggregated level within the entity, and not limited by a narrow definition of portfolios.

#### 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?



We believe that an entity should primarily use the historical average loss rate, as they do not know what the future will be. 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 not be appropriate, as this would lead to unnecessary speculation about the future resulting in meaningless and unreliable financial reporting.

We believe that the proposed method of using probability-weighted possible outcomes should be removed, as it does not give any better financial information on the performance of a loan. Future possible scenarios should also be excluded from the impairment measurement method, as using historical data and statistics will result in more reliable results.

**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)?

We agree in requiring that an appropriate historical loss rate (including a full economic cycle, adjusted for existing economic factors and conditions) be determined for each individual pool of similar financial assets.

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?

Consistent with our previous comments on impairment of portfolios, the recognition of interest income should not be affected by the recognition or reversal of credit impairments. The expected credit loss should not be consider by the contractual terms based EIR. Instead, the model should use the current definition of amortized cost and the EIR calculation. The current EIR calculation and expected loss rate should be separate in their calculations and their reporting in the income statement. We believe decoupling the interest rate from the expected loss information would have a number of advantages, in that it would:

- o provide more transparent and understandable information for users;
- o align more closely with management's approach to credit risk;
- o avoid unit of account issues between expected losses calculated on a portfolio basis and EIR calculated on a loan basis; and
- o be more feasibly operational, and so might reduce the timeline required for the implementation of the proposals.

By doing this, the expected loss rate has no impact on the interest income calculation, but has a final net effect in the income statement.



We believe that instruments that are held for the collection of cash flows should be measured using amortized cost and not fair value.

**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?

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 not be recognized as an increase to the allowance for credit losses, as the model should not be based on expected cash flows, but instead focus on expected losses. (see decoupling comments above) If there are specific events that have occurred where you have a loss event, then this should be taken against the provision, which has been built-up over time.

**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?

No, we do not believe it is necessary to specify a particular method for determining the amount of interest income to be recognized on the face of the income statement.

**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?

We do not agree with the underlying methodology used in the implementation guidance and illustrative examples, as in the previous questions.

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, it is appropriate to modify the effectiveness threshold from highly effective to reasonable effective, which will help in the simplification of hedge accounting.

Hedge accounting should reflect the entity's business model in terms of its reduction of risk exposure and sensitivity. This action taken by the entity should be reflected in the financial statements. It should be principle based in order to be more robust and more responsive to



possible future developments in markets, products and hedging strategies.

The key aspects of hedge accounting should be:

- Economic cash flows should take precedence over contractual cash flows. This is
  particularly the case for deposits, where economic cash flows continue beyond the
  contractual maturity and assets that are subject to early redemption where the
  embedded early payment option means that expected cash flows end before their
  contractual maturity.
- The effectiveness of a hedge should be aligned with its objective. For example, when the objective is to under-hedge a risk exposure, the hedging relationship should be considered effective if there is an under hedge in place. The under hedge should apply to both balances and maturities (partial hedging is a form of under hedging). This corresponds to a bottom layer approach, which means that the hedged portion is defined as the bottom layer of the portfolio. In this case, the term portion refers to a part of the instrument (the hedge covers a part of the life of the instrument) that is part of a population of similar items, for example, as some loans can be prepaid before their maturities, a practical way to take this feature into consideration is to under hedge the entire loan portfolio.

**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?

We agree that no effectiveness evaluation need 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. As the key terms of the instruments need to match at inception, unless these change, the instruments should remain reasonably effective.

**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?

Yes, requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would potentially result in a reduction in the number of times hedging relationships would be discontinued.

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 believe that the FASB should remove the term "exactly" offsets the hedged cash flows, as the entity needs to document how the offset is going to be structured.

**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?

No, we do not 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.

**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, we foresee 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. We completely disagree with the proposed change to prohibit voluntarily dedesignation of a hedge accounting relationship found in the Update. In addition, the proposed guidance on effective terminations is nonoperational and cost prohibitive. Companies commonly add new hedging relationships and remove, or dedesignate, existing hedge relationships, as changes occur in the risk profile of the hedged risk exposure. As such risk management strategies are prudent and appropriate, we find the FASB's basis for conclusions regarding dedesignation to be flawed and inaccurate. Because hedge accounting designations must be made in advance of market movements, we do not understand how an earnings recognition-based intent could ever be realized through a decision to dedesignate.

**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?

Yes, we foresee significant operational concerns and 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. The proposed conditions for a permissible dedesignation are unnecessarily restrictive. Entering into an offsetting derivative is a costly and unnecessary expense when the existing derivative may be reused and possibly redesignated for other purposes including risk management in a qualifying hedge accounting relationship. Terminating a derivative may also have significant negative liquidity impacts as a result of having to settle a derivative payable prior to the scheduled maturity. This dedesignation restriction will complicate or prohibit many common hedge strategies used today.



We believe that the proposed provisions precluding the original hedging derivative and the new offsetting derivative to be redesignated in a new hedge accounting relationship for their remaining lives burdensome and nonoperational. Entities seeking to manage risk prudently will be forced to execute additional derivative transactions when additional risk exposures arise, which means that this fails to meet any cost/benefit analysis. Entities with large numbers of derivatives that need to terminate a hedge relationship by entering into an offsetting derivative, would be burdened with creating and tracking new information that allows the entity to identify derivatives that are no longer eligible for hedge accounting relationships for a prolonged period of time. This will require significant modifications to transaction systems infrastructure and additional monitoring and is further exacerbated when applied to a hedging instrument composed of multiple derivatives.

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?

As we do not agree with the underlying methodology, as in the previous questions, we do not agree with the proposed disclosure requirements. We believe the proposed disclosures will also create operational problems. The disclosures required by the ED are extensive, and come on top of already extensive disclosures for financial instruments. In addition, management would not use much of the information required. In our view, the FASB has not carried out an adequate analysis of the costs of preparing such disclosures against the benefits that users would derive from them. Developing the operational processes and system capacity to generate such disclosures would be exceptionally resource intensive and costly.

Due to the requirement for such vast amounts of data, many of the required disclosures would lead to boilerplate disclosures or information that is too voluminous and impractical to prepare to be meaningful at all.

Effective Date and Transition Questions for All Respondents

 $\textbf{Question 68:} \ \ Do\ you\ agree\ with\ the\ transition\ provision\ in\ this\ proposed\ Update?\ If\ not,\ why?$ 

We disagree with the proposed transition guidance. For example, the hedge accounting related amendments would require retrospective application of the proposed changes to hedging instruments/hedging relationships that were in place prior to and which exist at the date of transition. It is unclear how the transition guidance would be applied for hedge



relationships that exist as of the initial date of adoption but which were dedesignated and redesignated in periods prior to transition. We believe any requirement to apply the proposed rule that prohibits or restricts dedesignation retrospectively would fail the most basic of cost-benefit tests. Therefore, the final standard should require only prospective application of the proposed hedge accounting provisions to qualifying hedge accounting relationships that are newly designated in periods subsequent to the initial date of adoption with no restatement required for hedge accounting relationships reported in periods prior to adoption. All continuing hedge relationships established prior to the effective date should be grandfathered and accounted for under the hedge rules existing at the time of designation until these hedges mature, are terminated or no longer qualify for hedge accounting.

**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. It should not be the role of the standard setter to determine which standards apply to which companies. This is the role of local regulators that these entities have to report to.

Questions for Preparers and Auditors

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

Based on the current proposal, a long lead-time will be required for implementation given the extent of development and modifications required to systems and processes.

Furthermore, in setting the mandatory effective date, the FASB should take into account the implementation requirements for the other aspects of all other upcoming US GAAP pronouncements and the various other projects that it is currently working on.

If our suggested improvements are adopted and a model is developed which more closely aligns with management's approach, then a shorter implementation period could be possible.

 $\textbf{Question 71:} \ Do \ you \ believe \ the \ proposed \ transition \ provision \ is \ operational? \ If \ not, \ why?$ 

No, we do not believe the proposed transition provision is operational. See our response to question 68.