



September 30, 2010

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
File Reference No: 1810-100

Re: Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative and Hedging Activities

Dear Mr. Golden:

The Loan Syndications and Trading Association (LSTA)¹ appreciates the opportunity to comment on the FASB's proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative and Hedging Activities* (the "proposed ASU").

The LSTA supports the FASB's efforts to reduce complexity in financial reporting and to provide users of financial statement with a more timely and representative depiction of an entity's involvements with financial instruments. However, the LSTA does not support the issuance of the proposed ASU as currently drafted because (1) it is not sufficiently converged with the classification and measurement principles in International Financial Reporting Standard (IFRS) No. 9, *Financial Instruments: Classification and Measurement* (IFRS 9), (2) it does not provide information to users of financial statements that is consistent with an entity's business purpose and investment strategy and (3) it contains an impairment model that is not consistent with how credit risk is typically managed in practice.

Given the FASB's and IASB's commitments to international convergence of accounting standards and the importance of convergence as a cornerstone to the SEC's Work Plan on IFRS, the LSTA believes it is critically important that any accounting standard of this magnitude be substantially converged.

¹ The LSTA represents over 300 of the largest US and foreign banks, broker dealers, hedge funds, mutual funds, insurance companies, and institutional investors. The LSTA was founded in 1995 with the objective to improve liquidity and transparency in the floating rate corporate loan market. As the principal advocate for this asset class, the LSTA fosters fair and consistent market practices to advance the interest of the marketplace as a whole while promoting the highest degree of confidence for investors of corporate loans. The LSTA undertakes a variety of activities to develop policies and market practices designed to advance just and equitable marketplace principles and to encourage coordination with firms, facilitating transactions in loans and related claims.

First and foremost, most LSTA members are multinational corporations with reporting requirements under both US GAAP and IFRSs. The LSTA believes that requiring multinational corporations to adopt two significantly different accounting models for financial instruments will significantly increase complexity in financial reporting associated with continuous dual reporting. In addition, the LSTA strongly believes that a global set of converged accounting standards provide a level playing field for global organizations regardless of their basis of accounting and will provide users of the financial statements with consistent high quality comparable information. We are particularly concerned about the FASB's and IASB's inability to conform to the Memorandum of Understanding (MoU) on international convergence that was reaffirmed in November of 2009, specifically as it relates to financial instruments. The LSTA strongly encourages both Boards to remain committed to the MoU.

Second, and as discussed in more detail below, the LSTA believes the proposed ASU will require significant and costly changes to financial reporting systems and related processes. While we support changes which will provide an improved and consistent financial reporting model for recognition, measurement and presentation of financial instruments, we believe that the proposed ASU is not able to achieve such objective by simply expanding the use of fair value as a measurement attribute for most financial instruments.

Depending on the direction of future rulemaking by the SEC related to IFRS and the potential short time period that any system modifications will be effective, the LSTA does not believe these costs necessary to implement the proposed ASU are justified. Further, upon the eventual conversion to IFRS, additional systems modifications will be necessary to the extent that US GAAP and IFRSs are not substantially converged. Not only are these continuous modifications costly, the LSTA believes that adopting two significantly different models to account for financial instruments over a short period of time will actually increase complexity in financial reporting which is counter to one of the primary objectives of proposed ASU.

Based on the points above, the LSTA does not believe the perceived short-term benefits of expanding the use of fair value as a measurement attribute as proposed by the ASU outweighs the costs of producing this financial information. Rather than issue the proposed ASU as a final standard, the LSTA recommends that the FASB adopt the classification and measurement principles in IFRS 9 and work closely with the IASB to develop converged impairment and hedge accounting models that can be applied to all entities reporting under US GAAP and IFRSs.

If the FASB decides to proceed and issue the proposed ASU as a final standard, the FASB should consider revising certain aspects of the proposed ASU as further explained below.

Classification and Measurement:

Convergence

We do agree with the FASB's objective of the proposed ASU to provide an improved and consistent financial reporting model for the recognition, measurement, and presentation of financial instruments. However, we disagree with the FASB's belief that the proposed model increases the decision usefulness of the information provided in the financial statements to users simply by expanding the use of fair value measurements. In today's global economies and

capital markets, users of financial statements seek cross border comparability and accordingly, the LSTA believes that one of the primary objectives of the FASB in issuing any new standard of this magnitude should be convergence with IFRS. Consistent with that objective, the LSTA strongly encourages the FASB to adopt the classification and measurement model in IFRS 9.

Relevance and reliability of measuring loans at fair value on the face of the balance sheet

Our member organizations include loan market participants both in the buy and sell sides, where both amortized cost and fair value are used as the measurement attributes for loans depending on the nature of the organization's business and investment strategy. This mixed measurement attribute model is best captured by the classification and measurement model of IFRS 9 whereby an investor with a business model to originate/buy and hold loans (business model test)—with the objective to collect contractual cash flows that are solely principal and interest (cash flow test)—is required to measure such investments at amortized cost. Such a measurement attribute provides the most relevant information about the performance of the investor's business where the focus of the investment strategy is on yield generated by managing credit and interest rate risk over the life of the loan without being subject to short-term market risk volatility of interest rates or liquidity. Loan investors who actively engage in trading of such instruments with returns based on overall market price movement, should measure such loans at fair value through earnings. Loans originated with the intent to hold, consistent with a company's business model, should be accounted for based on the amortized cost method. The LSTA found that member organizations, held the common view that classification and measurement should be based on an entity's business purpose and investment strategy.

Additionally, as the general purpose of financial statements is to present the results and financial position of an entity consistently with how that entity is managed, the LSTA believes that requiring substantially all financial instruments be measured at fair value (irrespective of an entity's business purpose or investment strategy) is inconsistent with such conceptual framework.

Further, the LSTA does not believe that measuring financial instruments at fair value through other comprehensive income will be representative of the expected cash flows that an entity anticipates realizing over the life of a financial instrument. Finally, while this measurement approach artificially increases the volatility of stockholders' equity, it is not representative of the actual risks to which an entity is exposed.

Many companies have developed their financial reporting systems and internal control procedures to be consistent with their business model of generating and reporting revenue to their investors. Requiring that all financial instruments be measured at fair value on a recurring basis (including loans with contractual cash flows in which the entity's business model is to hold for the foreseeable future) will require significant modifications to financial reporting systems and internal control procedures. Such modification will come with considerable operational challenges and costs to implement, as follows:

First, the proposed ASU requires substantially all loans to be measured at fair value (either through net income or other comprehensive income) on the face of the balance sheet, which will require the reporting of fair value information for loans upon earnings release date which is a

much accelerated timeline compared to current reporting of fair value information pursuant to Accounting Standards Codification (ASC) 825-10-50 (previously FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*). Current systems and processes related to determining fair value of loans will have to undergo major reengineering to be able to provide fair value information more frequently than on a quarterly basis. Additionally, this requirement may undermine the reliability of financial statements because the majority of loans intended to be held to maturity have no active secondary market; therefore, estimating the fair value of Level 3 assets on the face of the balance sheet will necessitate significant valuation modeling. Currently fair value measurement level disclosures are not required for classes of instruments not measured at fair value in the balance sheet but for which the fair value is nevertheless disclosed².

Second, the proposed ASU requires both fair value and amortized cost information to be presented on the face of the balance sheet. Such dual reporting requirement, which appears to be driven by the desire to appease different constituents' views about what represents the most appropriate measurement attribute for financial instruments, introduces significant operational challenges as preparers will need to maintain legacy systems and processes used to calculate amortized cost while building new, or enhancing current systems and processes to capture fair value information for such instruments. Many of the LSTA's members who measure loans at amortized cost have established extensive systems and processes to measure performance based on the yield earned over time. This measurement and evaluation practice, consistent with the expectations of their investors, results in a stable, predictable, and measurable process which can be appropriately budgeted for. Discarding this process for a market based process will result in increased volatility and disconnect between financial reporting and how a lending institution manages credit risk. Finally, we believe that the proposed ASU does not achieve the desired simplification as the number of categories for financial instruments is not significantly reduced. While our letter focuses primarily on loans, we are concerned about the fact that the proposed ASU still retains six categories of financial assets and financial liabilities which will not eliminate the operational challenges described above and will likely fail to achieve the FASB's objective to reduce complexity related to reporting for financial instruments.

Based on the above, the LSTA strongly encourages the FASB to adopt a classification and measurement approach for loans that is similar to IFRS 9. Specifically, the LSTA believes that an entity should be able to classify and measure a financial asset at amortized cost if (1) the business purpose and strategy for investing in the financial asset is to collect contractual cash flows and not to realize short term trade gains and (2) the financial asset (a) has contractual cash flows that represent only principal and interest payments (b) does not contain any embedded derivatives that would otherwise require bifurcation and (c) cannot be contractually settled in such a way that the investor would not recover substantially all of its recorded investment.

Loan commitments

Similar to the views expressed above, the LSTA also believes that the classification and measurement of loan origination commitments should be consistent with how the entity will manage the underlying loan once originated. The LSTA does not support the requirement in

²FASB proposed Accounting Standards Update (ASU), *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, proposes changing this disclosure requirement.

paragraph 25 of the proposed ASU to measure all loan commitments at fair value on the balance sheet (whether through net income or other comprehensive income) unless the loan commitment meets the definition of a derivative instrument under ASC 815, *Derivatives and Hedging*. The LSTA believes the requirement in the proposed ASU to measure all loan commitments at fair value will significantly increase the cost of financial reporting because of the difficulty in determining the fair value of a loan commitment. Unlike other financial assets, the fair value of a loan commitment is significantly impacted by the likelihood that the borrower ultimately decides to enter into a loan during the commitment period. Some of the factors impacting a borrower's decision are not market factors which make it difficult in practice to predict when a borrower will actually enter into a loan.

Rather than requiring all loan commitments to be classified and measured at fair value on a recurring basis, the LSTA believes the classification and measurement of a loan commitment should be consistent with the entity's ultimate business purpose and strategy for extending the underlying loan. Consistent with the proposed model above, the LSTA believes a loan commitment should be classified and measured at fair value through earnings only if the entity's business model and strategy for originating the loan subject to a loan commitment is to sell the loan in the market to generate trading gains. Alternatively, if an entity intends to hold the underlying loan into the foreseeable future for purposes of generating a yield over the life of the loan, the LSTA believes that the loan commitment should also be classified and measured at amortized cost.

Reclassification subsequent to initial recognition

The LSTA also disagrees with the restriction in paragraph 23 of the proposed ASU to reclassify financial instruments to the extent that facts and circumstances change after initial recognition. While we do anticipate such changes in the business model to be rare, the LSTA believes that an entity should reclassify financial instruments to the extent that its business model and strategy for investing in certain financial instruments changes. This will ensure that information in the financial statements is always consistent with how an entity manages its investment portfolio.

Fair value option

Finally, based on our preferred classification and measurement described above, the LSTA also supports the continuation of the fair value option for financial assets and financial liabilities not measured at fair value through earnings. To the extent that an entity's business purpose and strategy for investing in a financial asset is to hold the asset for the foreseeable future to collect its contractual cash flows, the LSTA believes entities should still have the option to measure the financial asset or financial liability at fair value through current period earnings if that measurement attribute will eliminate an accounting mismatch without having to apply costly hedge accounting requirements. We also encourage the Board to propose additional disclosure requirements when fair value elections are made in order to facilitate users' understanding of the rationale for such elections and the implications of such elections on financial results.

Measurement of Credit Impairment:

The LSTA is concerned about the lack of convergence of the proposed ASU and the IASB's ED, *Financial Instruments: Amortized Cost and Impairment* and encourages the FASB to continue working with the IASB to develop one single high quality impairment standard that will address current conceptual, operational and application challenges related to this important area while working simultaneously with the Expert Advisory Panel and constituents to achieve such objective. The following are our comments specific to the FASB proposed credit impairment model.

Expectations of future events

Specific to the impairment model in the proposed ASU, the LSTA disagrees with the requirement in paragraph 42 of proposed ASU that "an entity shall assume that the economic conditions existing at that point in time would remain unchanged for the remaining life of the financial assets. An entity shall not forecast future events or economic conditions that did not exist at the reporting date in determining whether a credit impairment exists." Under the proposed ASU, impairment is determined based upon the creditor's expectation about future cash flows. However, the LSTA does not believe the proposed ASU provides clear guidance on how to estimate future cash flows without consideration of future events or forward looking information. The LSTA also notes that some of the indicators of credit impairment would factor in forward looking information. For example, the indicators of credit impairment in paragraph 43 of the proposed ASU include expectations about future default and credit ratings. Further, assuming that current conditions remain unchanged in all circumstances is not realistic and is not consistent with the fundamentals of determining impairment losses in practice. The LSTA believes management should be able to apply judgment in arriving at the best estimate of credit impairment, which may necessitate projecting future conditions over a reasonable future period by taking into consideration the availability and reliability of data to support credit loss estimates.

The view of the LSTA is that credit impairment should consider some forward looking information. The LSTA acknowledges that forecasting future events over the life of the financial instrument increases the level of subjectivity in the estimate of credit impairment, especially for longer dated financial instruments. However, an impairment model that considers events over the foreseeable future, rather than over the life of the instrument, would result in a better measure of expected future cash flows. As such, the LSTA strongly recommends that the FASB and IASB work together, with the joint Expert Advisory Panel and other constituents, to develop a converged model that achieves the objective of measuring credit impairment based upon management's best estimate of credit losses. The converged principles-based model should then be re-exposed to constituents for comment.

Single impairment model

The LSTA supports a framework in which a single impairment model for both originated and purchased credit impaired loans is applicable for all financial instruments not carried at fair value through earnings. A single impairment model will reduce the current complexity in accounting for financial instrument impairment and is consistent with the objective of developing principles-based standards. Consistent with this view, the LSTA does not support the continuation of a different impairment model that is specifically applicable to purchased financial assets with

credit deterioration. Rather, the LSTA supports an impairment model that allows an entity that purchases a financial asset to establish an allowance for credit losses upon acquisition that is determined through the normal credit review process and subsequently maintains that allowance on a basis consistent the methodology for originated financial assets. Additionally, the LSTA agrees that credit impairments should only result from changes in expected cash flows due to changes in credit and should not be based on consideration of other risk factors such as interest rates or foreign exchange rates.

Coupling of impairment and yield accretion

The LSTA does not support the requirement in paragraph 76 of the proposed ASU that previous credit impairments impact the calculation of interest income accruals. Determining interest income based upon the loan's carrying value net of the allowance for loan losses does not reflect risk management practices for financial instruments that are not managed on a fair value basis. For these types of financial instruments, credit risk is managed separately from interest rate and other risks in the loan portfolios. Also, the LSTA believes this requirement will require significant systems modifications and the development of a methodology to allocate any pool based allowance to individual loans. Further, the LSTA understands based on discussions with analysts and other financial statement users that comingling interest income and credit impairment recognition is not considered meaningful information as that is not how performance of financial institutions is evaluated.

Financial assets evaluated in a pool

The LSTA does not believe that a specific method should be prescribed for determining historical loss rates for determining credit impairment in a pool of financial assets. Rather, the LSTA believes the Board should strive to issue principle-based standards. The LSTA notes that historical loss rates applied to pools of similar financial assets typically reflect a shorter time frame than the expected life of the financial assets and the proposed approach would result in a change in practice. The proposed guidance may present operational difficulty for longer dated financial instruments, if that historical data does not exist.

Hedge Accounting:

Simplification of hedge accounting criteria

The LSTA is generally supportive of the proposed ASU's modifications to the hedge accounting model in ASC 815. Specifically, the LSTA agrees with removing the quantitative hedge effectiveness assessments in favor of a qualitative assessment and with removing the shortcut and critical terms match methods. We are also supportive of lowering the threshold to apply hedge accounting from highly effective to reasonably effective, however we believe that further clarification is needed to what is deemed reasonably effective. *Dedesignation subsequent to initial designation*

The LSTA does not support the restriction in paragraph 119 of the proposed ASU on de-designation of a hedging relationship unless the hedging instrument is terminated (or a mirror image hedging instrument is entered into) or the hedging relationship no longer qualifies for

hedge accounting. The LSTA conceptually disagrees with the views of the FASB that de-designation of a hedging relationship should not be elective. The LSTA believes that because hedge accounting is elective in the first place, de-designation of a hedging relationship should also be elective. The LSTA also does not share the same concerns as the FASB that allowing de-designation may provide an opportunity to manage earnings. Rather, the LSTA believes that when a fair value hedge or a cash flow hedge is de-designated, there are sufficient restrictions in place in ASC 815 regarding when the amounts deferred in OCI for a cash flow hedge or the basis adjustment to the hedged item in a fair value hedge may be recognized in earnings. Generally, these amounts are not recognized in earnings immediately but over the remaining life of the original hedged item.

Finally, the LSTA also notes that the ability to de-designate a hedging relationship without terminating the hedging relationship is a critical component to certain dynamic fair value hedging strategies that are often used to hedge fixed rate loans and servicing assets. Restricting de-designation to situations where the hedging instrument is terminated or a mirror image hedging instrument is entered into will significantly increase the cost of employing a dynamic fair value hedging strategy and will inevitably reduce the viability of a dynamic hedging strategy.

We truly appreciate the opportunity to share the loan industry's perspective on the proposed ASU. If you have any questions concerning our comments or suggestions, please contact Sherif Sakr at (212) 436-6042 or Ellen Hefferan at (212) 880-3013.

Yours truly,



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