

On Your Side®

September 30, 2010

Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

Re: File Reference No. 1810-100 – Proposed Accounting Standards Update – Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (Topics 815 and 825)

Dear Mr. Golden:

Nationwide Insurance appreciates the opportunity to comment on the Exposure Draft of the Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (Topics 815 and 825)* (Proposed ASU). The Nationwide Insurance Enterprise (Nationwide) is comprised of three affiliated mutual insurance companies and their subsidiaries under common management. Nationwide is one of the largest diversified insurance and financial services organizations in the world with 2009 annual revenues of \$21 billion and assets totaling \$140 billion.

We support the Financial Accounting Standards Board's (FASB) main objective to provide financial statement users with a timely and representative depiction of an entity's involvement in financial instruments, while reducing the complexity in accounting for those instruments. We also strongly support coordinated convergence efforts with the International Accounting Standards Board (IASB) to improve global financial reporting consistency and comparability for financial statement users. Convergence will also help minimize implementation costs for financial statement preparers that intend to convert to international accounting standards in the future. Our comments are directed towards enhancing the Proposed ASU to achieve these broad objectives. As the insurance industry is one of the largest participants in the financial markets with trillions of dollars invested in assets and because Nationwide is a major institutional investor, we are in the unique position of expressing views from a preparer and investor perspective.

Nationwide respectfully requests consideration of the following main recommendations for the financial instrument joint project.

The balance sheet should be reflective of management's business strategy with
corresponding assets and liabilities measured on the same basis. We believe that amortized
cost is a more appropriate measure for balance sheet presentation in cases where the
business strategy entails Asset and Liability Management (ALM), with corresponding
liabilities carried on a cost basis.

- The business strategy criteria should be modified to better align with management's risk strategy practices, similar to existing IFRS guidance. Specifically, we request that the Proposed ASU allow for reasonable sales activity which reflects prudent risk management strategies.
- Allow all asset classes, especially mortgage loans and hybrid instruments, to utilize the risk management strategy criteria for "special" accounting treatment. We believe that the business strategy principle may be appropriate regardless of financial instrument structure depending on facts and circumstances.
- Reclassifications should be allowed if a business model or accounting guidance change creates asymmetrical accounting.
- A balance between conceptual and practical application should be seriously considered before
  wholesale changes are made to existing business practices. As such, the calculation of interest
  income should remain using the amortized cost basis, rather than the balance net of credit losses.
- Expected cash flows used to determine credit impairments should utilize all relevant information and estimates of future variables that are available to management. We believe that as proposed, the limitation based solely on past events and current conditions is not consistent with a market participant's view, which also considers reliable estimates of future variables.
- Clarification that the Proposed ASU does not modify current tax accounting guidance including utilizing valid tax planning strategies for evaluation of deferred tax assets.

We expound on our recommendations in more detail below.

# **COMPREHENSIVE RECOMMENDATIONS:**

## Management Risk Strategy and Amortized Cost

The fundamental principle that the FASB should use as the basis for all classification and measurement decisions is that the balance sheet should reflect management's risk strategies. ALM is the practice of managing the risks of asset and liability mismatches by matching the assets and liabilities according to their duration. We believe that the balance sheet should reflect this practice or other risk strategies utilized by management.

For most insurance liabilities, we believe a model consistent with amortized cost attributes is most appropriate. A financial liability that has limited market activity, such as an insurance liability, should not have a measurement attribute primarily based on fair value characteristics. Both management and investors are more concerned with how assets and liabilities are matched and risk managed that volatility caused by short-term market fluctuations. Fair value information for financial instruments is important to disclose for investors. However, we believe that the volatility in equity caused by fair value accounting has an inadvertent adverse impact on companies with otherwise sound asset liability risk management practices. An amortized cost model for matched financial assets and liabilities minimizes the pro-cyclical affect to the balance sheet resulting from point in time fair value measurements.

During the last economic downturn, fair value accounting through other comprehensive income (OCI) created unnecessary volatility in equity and exposure for instruments held for a significant portion of their contractual cash flows as part of an ALM strategy. This flaw was particularly evident during the recent economic downturn when the fair value of assets experienced significant fluctuations due to illiquidity within the markets and investor uncertainty. For insurers, fair value fluctuations were not

reflected within corresponding policyholder reserve and claim liabilities which created an artificial accounting mismatch not reflective of managements' risk strategies. This phenomenon also holds true during periods where a point in time view of the balance sheet includes large unrealized gains which also are not indicative of the true business results that a model with matching assets and liabilities at amortized cost would convey. We note that these concerns are shared by the international community which accordingly has supported an amortized cost model instead of fair value model with adjustments in OCI. We believe this model should be embraced by the FASB as well.

Insurance companies are large participants in the capital markets and have a vested interest to ensure full transparency is provided within financial statements. When performing analysis of potential investments, we utilize some of the fair value information that is currently disclosed. Therefore, we feel disclosure of fair value information within the footnotes, coupled with the suggested changes toward amortized cost, is appropriate for both financial statement preparers and users

# **Business Strategy Criteria**

The Proposed ASU uses fair value with adjustments through net income as the default classification and measurement model, unless certain criteria outlined about the type of instrument and business strategy have been met. We agree that the business strategy should be to collect or pay the related contractual cash flows rather than to sell the financial asset or settle the financial liability with a third party; however, we are concerned that the other outlined criteria related to holding instruments for a significant portion of the cash flows and the level the business strategy test should be performed are too restrictive and could be confusing in application. To address this concern, we respectfully request that the business strategy criteria be modified to better align with management's risk strategy practices, similar to existing IFRS criteria. We believe that existing IFRS guidance provides the flexibility needed to determine at what level the business strategy should be proven. This would align more with how a company is managing its business. In addition, we request that the Proposed ASU allow for reasonable sales activity which reflects prudent risk management strategies. Specifically, valid reasons for sales including portfolio rebalancing, meeting liquidity needs, and staying within prescribed portfolio risk thresholds are all circumstances which reflect prudent risk management strategies that should not be discouraged by the accounting guidance.

### Consistent Application of Classification and Measurement and Reclassifications

We believe that management's risk strategies should be reflected on the balance sheet and applied consistently across all financial instrument asset classes. The business strategy principle may be appropriate regardless of financial instrument structure depending on facts and circumstances. As a result, we support the FASB's efforts to align mortgage loans held for investment with the accounting of instruments managed for similar purposes. We also support that trading, mortgage loans held for sale, and other investments that cannot meet the business strategy criteria should be recognized at fair value through net income. We do not feel that certain financial instruments should be unilaterally precluded from utilizing the accounting treatment afforded other financial instruments managed under the same business strategy.

For instance, we do not believe that hybrid instruments which contain an embedded derivative should preclude accounting for the instrument in a manner that reflects management's risk strategy for the asset. Certain structured liabilities issued by entities, and certain corporate bonds with call features are deemed to contain an embedded derivative. Both of these financial instruments can be used for risk

management strategies. However, the existence of an embedded derivative would preclude the host contract from being accounted for in accordance with the economics of management's risk strategy. For example, a debt instrument with a conversion option embedded will be reported at fair value but an identical debt instrument where the conversion option is written as a separate contract will be reported at amortized cost and the option at fair value. We believe that inconsistency of accounting treatment for financial instruments with identical economic effects, but different legal structures is undesirable. Therefore, we do not believe that hybrid instruments with a financial host and an embedded derivative should always be accounted for in its entirety at fair value through net income.

We believe that prohibiting reclassifications of financial instruments after initial recognition is counter intuitive from the principal to align balance sheet presentation with management's risk strategy. Instead, we suggest that reclassifications would be required if there is a change in business model from prudent risk management activities, such as portfolio rebalancing. Additionally, we would request that reclassification is allowed if accounting guidance changes that create asymmetrical accounting. Our view is that categories for classification should endeavor to reflect the risk management strategy as of the balance sheet date to ensure that financial statements appropriately convey management's current risk strategies to the financial statement users. Another positive outcome is to improve comparability between entities without the need for extensive disclosure as a financial statement user can view an entity's balance sheet and easily understand the management's business strategy at that point without needing to refer to extensive disclosures which otherwise would be necessary to explain where business models had changed since inception of an instrument.

# Balance between Conceptual and Practical Application

Overall, we do not support that entities should calculate interest income by using the amortized cost balance adjusted for credit losses. We believe that this new requirement would create comparability issues between entities relating to "core" operating income items depending on management's reserve policies and procedures. Although reserve policies would be disclosed, comparison of key financial measures from the face of the income statement and balance sheet utilized by both management and investors will become less transparent. These comparability issues would be exacerbated by different impairment methodologies and subjectivity included in the cash flow estimate. Interest income presented on the income statement would not represent "pure" interest associated with credit losses since changes in expected cash flows would not be retrospectively adjusted through interest income. Instead, expected cash flow changes would flow through the provision for credit impairments on the income statement. Another important consideration is that recording the interest income associated with the difference between the amortized cost basis and net balance adjusted for credit losses is inconsistent with the way entities handle expenses associated with liabilities. If interest income is being split between interest income and allowance for credit losses, the Proposed ASU would create a mismatch between assets and liabilities and skew operating results. This would also be confusing to financial statement users, many of which use the comparison of interest income and the associated interest expense as a key financial statement metric.

As an alternative, we suggest that the calculation of interest income be based on the amortized cost basis. We believe that a gross yield is more relevant and less subjective than the proposed method. Yield is a key financial metric that companies and investors use when comparing results. We believe this alternative approach would produce results with greater comparability and consistency across companies. Currently, investors rely heavily on the ability to calculate and compare book yield and an interest spread of a business. The Proposed ASU would significantly convolute this analysis making

assessment of operating results more difficult to assess. Investment systems have developed complex and highly integrated automation to account for and report interest yield. The Proposed ASU would have a significant impact on these applicable systems and related processes resulting in material implementation costs. The impact of changing the method of recognizing interest income will likely be burdensome and disruptive. The operational cost of actively tracking these adjustments at a CUSIP level for thousands of securities would require a large financial undertaking for limited benefit.

## Other Comments and Recommendations

*Equity Method of Accounting (Classification and Measurement)* 

The Proposed ASU requires an entity to determine that the operations of the investee are related to the entity's consolidated business. We are concerned that this test is inconsistent with the guidance used in consolidation accounting, which does not require that the operations be consistent to consolidate but rather uses power to control the most significant activities as the key accounting model determinant. We are concerned that the factors outlined in the Proposed ASU may make this test difficult to apply causing inconsistency between companies. The examples of factors to consider included in the Proposed ASU appear focused on traditional manufacturing entities. Many entities have diverse businesses or are entirely a non-manufacturing business, such as financial service companies. Accordingly, there will be significant variability as to what is considered similar to an entity's operations and the proposed factors do not address this variability. For these reasons, we believe that power to exhibit significant influence should continue to be the only criteria used for equity method investments and the criteria that the operations of the investee are related to the entity's consolidated business should be removed from the Proposed ASU.

#### Core Deposit Liabilities (Classification and Measurement)

While primarily an insurance entity, Nationwide also has a consolidating thrift with core deposit liabilities and is a significant investor in the financial services sector. We believe that amortized cost is the most appropriate valuation model for core deposit liabilities. The proposed valuation method will mask the effects of changes in balances from period to period. Movements in deposits are critical for financial statement users' view of growth and/ or maturity exposure. Any remeasurement by product type would be subject to significant swings in the balances in many account types. Amortized cost is much more appropriate for the true value of these deposits as the inflows and outflows are unpredictable. Furthermore, the remeasurement approach will be operationally burdensome and subjective in nature as determining which to expenses to include in the discount rate will vary from entity to entity based on their business model. As such, we propose that the amortized cost method be retained.

#### Individual Verses Pooled Credit Impairment Assessment Models (Credit Impairments)

We agree with eliminating the "probable" threshold for loans and the "underwater" threshold for securities as triggers to consider the financial asset individually for impairment. This change would permit entities a degree of flexibility in establishing their reserves, while not limiting credit losses to be recognized based solely on objective evidence of impairment. Further, we fully support the flexibility that the Proposed ASU provides management when determining whether the use of the individual or pooled credit impairment assessment methodologies is more appropriate. We agree that entities should be allowed latitude in the assessment model, individual or pooled, used for identifying and measuring

credit impairment based on their specific facts and circumstances of their financial assets and portfolios.

Cash Flow Estimates (Credit Impairments)

We disagree with the method of determining cash flow estimates that was included in the Proposed ASU. Under the exposed guidance, cash flow estimates should be determined based on past events and current conditions, and should not give consideration to future events. We believe that as proposed, the limitation based solely on past events and current conditions is not consistent with a market participant's view, which considers reliable estimates of future variables. It is unrealistic and overly prescriptive to require entities to assume that existing conditions would remain unchanged for the remaining life of the financial instrument being considered. Certain estimates of future activities can be reasonably estimated and should be included in the cash flow estimates. The use of static assumptions based only upon existing economic and market conditions would be extremely procyclical. Further, cash flow estimates and impairment reserves are inherently forward looking estimates so excluding all future variables is counterintuitive to this overall premise. Excluding the consideration of all future variables is inconsistent with how market participants typically assess cash flows. Market participants routinely include assumptions of certain future variables when developing fair value estimates and not including them would contradict the fundamental definition of fair value.

As such, we believe that proposed guidance should require that expected cash flows estimates used to determine credit impairments should utilize all relevant information and future variables available to management. Future variables to be considered should be based on reasonable and supportable forecasts, and could include items such as forward interest rate curves, home price movement and unemployment rates. We believe that "true" future events, such as legislation changes, should not be considered in expected cash flow estimates as these items would not be based on reasonable and supportable forecasts, until the event actually occurs.

This modification would make the exposure draft consistent with the fundamental concept of fair value and consistent with a market participant's view. In addition, this would help align the Proposed ASU regarding consideration of future events with proposed IFRS standards as seen in paragraph B57 through B60 of the proposed IFRS insurance contracts guidance.

## Deferred Taxes

The Proposed ASU requires that an entity evaluate the need for a valuation allowance relating to deferred tax assets associated with the unrealized losses of debt securities, for which qualifying changes in fair value are recognized in other comprehensive income, in combination with the entity's other deferred taxes assets. We believe that this does not change the way companies currently evaluate deferred taxes and that they can utilize valid tax planning strategies to support all or a portion of the overall deferred tax assets. To validate our interpretation, we respectfully request that clarification is added that the Proposed ASU does not modify current tax accounting guidance, including utilizing valid tax planning strategies for evaluation of deferred tax assets.

Hedge Effectiveness Testing (Derivatives and Hedging Activities)

We appreciate and fully support the changes to make effectiveness assessments simpler for companies. We believe that these changes will continue to allow companies to achieve the desired risk mitigation

of the hedged assets and liabilities, while making hedge accounting more meaningful and cost effective for companies to achieve. At the same time, it will continue to represent and reflect management's risk management program relating to hedging and make it meaningful and transparent to the financial statement users.

*Voluntary Hedge De-designation (Derivatives and Hedging Activities)* 

We believe that hedge accounting guidance should continue to allow voluntary de-designations in hedging relationships. There are legitimate risk management reasons why a company may want to discontinue a hedging relationship and prohibiting voluntary de-designation inhibits these business decisions. For instance, if facts and circumstances change, a company may want to discontinue hedge accounting on one relationship and use the current derivative in another hedging relationship. If voluntary de-designations are not permitted, companies would be compelled to enter into offsetting derivatives while simultaneously entering into a new derivative, even though it mirrors the dedesignated derivative, so that the other hedging relationship is achieved. This results in an increase in transaction costs to achieve the desired risk mitigation results where de-designation or the derivative and re-designation to the new hedge would avoid these costs. Prohibiting voluntary de-designation economically disadvantages companies for actively managing their portfolios and the associated risks. We propose that voluntary de-designations should continue to be permitted under the Proposed ASU to encourage prudent risk management practices in a cost efficient manner.

## Portfolio Hedging (Derivatives and Hedging Activities)

We believe the Proposed ASU should loosen the requirements surrounding portfolio hedge accounting. Companies can and do effectively manage risk of their portfolios using derivatives. However, due to current hedge accounting requirements, portfolio hedge accounting is extremely difficult and costly to achieve. We believe loosening the requirements will help align the Proposed ASU with hedge accounting requirements that are currently in place under IFRS, which allows portfolio hedge accounting. This is an area where we believe the FASB and IASB can converge to make one consistent, meaningful, and principles-based standard, which continues to be a focus of the joint projects. This will allow companies to mange the risks associated with their portfolio, while presenting it in a meaningful and transparent way to the financial statement users.

# Disclosures (Financial Statement Presentation and Disclosures)

In general, we support the concept of full disclosure of useful and meaningful information within the financial statements. Overall, we believe that the FASB should complete a comprehensive review of the disclosure framework to ensure the most useful and appropriate disclosures are being provided to the financial statement users. Also, as mentioned previously, we are in a unique position of being able to address the financial instruments joint project from a financial statement preparer as well as a financial statement user perspective. We reviewed and considered the disclosure requirements of the Proposed ASU from these perspectives, and we believe that the disclosures included in the Proposed ASU are meaningful and useful to the financial statement users, with exception of the measurement uncertainty analysis. We believe that the measurement uncertainty analysis will create incomparable and inconsistent information that will be misleading and not meaningful to the financial statement users.

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"Core" Financial Statement Presentation (Financial Statement Presentation and Disclosures)

We believe that the additional detail being proposed on the face of the "core" financial statements makes them confusing and less meaningful for the financial statement users. Information will be confusing and less meaningful to financial statement users because the "core" financial statement will be cluttered and no longer be a good summary of the company and business. If the FASB considers additional information useful, adding this information to the footnotes of the financial statement is an acceptable alternative to achieve the goal of providing the information in a clear and transparent method. Including the information in the footnotes of the financial statement gives the financial statement users access to the information, while providing it in a transparent and meaningful way that would be less confusing. Financial statement preparers use accurate information when compiling the footnotes and use appropriate and similar materiality decisions and rigor that are applied to the "core" financial statements. The financial statement users should be receptive to this alternative as it will allow them access to the information in a clear and meaningful method.

Effective Date (Financial Statement Presentation and Disclosures)

When considering the effective date of the Proposed ASU, we believe significant consideration should be provided to companies that prepare financial statements using a three year comparative presentation. If the effective date of the exposure draft is 2013, data capture will be required by these companies starting in 2011. If a final standard is issued during 2011, this will not allow sufficient time for making strategic business decisions with the effect on the financial statements known prior to the acquisition of financial instruments. Additionally, this particular adoption time frame may not be adequate to address the comprehensive nature of the Proposed ASU.

## **CONCLUSIONS:**

As mentioned above, we agree and support the FASB's main objective to provide financial statement users with a timely and representative depiction of an entity's involvement in financial instruments, while reducing the complexity in accounting for those instruments. Although there are significant differences between the Proposed ASU and the exposure draft released by the IASB, we support the overall convergence of future guidance between the two boards. We believe the recommendations discussed above below will provide clarity and help provide the financial statement users with transparent and meaningful financial information that depicts an entity's involvement in financial instruments and enhance the effectiveness of the Proposed ASU.

We hope these comments assist you during your redeliberations of the Proposed ASU. In the event that any Board or FASB staff member would like any further clarification of our positions we are happy to explain them in greater detail.

Respectfully.

Senior Vice President, Enterprise Controller and Chief Accounting Officer

Nationwide Insurance

James D. Benson