

September 30, 2010

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

Via email to director@fasb.org

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

Dear Mr. Golden:

Freddie Mac appreciates the opportunity to comment on the Exposure Draft for the proposed Accounting Standards Update of Topic 825, *Accounting for Financial Instruments* and Topic 815, *Accounting for Derivative Instruments and Hedging Activities* (the “proposed Update”).

Freddie Mac was chartered by Congress in 1970 to increase the availability of funds for home ownership by developing and maintaining a secondary market for residential mortgages. We participate in the secondary mortgage market principally by providing our credit guarantee on the mortgage-related securities we issue, and investing in mortgages and mortgage-related securities. We hold a significant amount of financial assets and liabilities. As of June 30, 2010, our consolidated balance sheet reflects over \$2.0 trillion of both financial assets and financial liabilities.

The views expressed in this comment letter are solely those of Freddie Mac, and do not purport to represent the views of the Federal Housing Finance Agency, as Conservator.

We support the Board’s efforts to amend Topic 825 and Topic 815 with the objectives of developing an improved and consistent financial reporting model for the recognition, measurement, and presentation of financial instruments in an entity’s financial statements and simplifying the accounting for hedging activities. However, we believe the guidance articulated in the proposed Update, taken as a whole, does not accomplish these objectives. We have several concerns with the guidance in the proposed Update, as follows:

- Convergence with International Financial Reporting Standards (“IFRS”) - The proposed Update does not achieve convergence with IFRS, primarily in the areas of subsequent measurement attribute and the credit impairment model;
- Subsequent Measurement Attribute - While we agree that information about the fair value of financial instruments is relevant and useful, we do not agree that fair value should be the measurement attribute in all cases. We believe the measurement attribute for financial instruments should be based on an entity’s business strategy for those instruments, which may include fair value or amortized cost less an allowance for credit losses for financial assets (hereinafter referred to as “amortized cost”);
- Financial Statement Presentation – The proposed financial statement presentation for financial instruments carried at fair value with qualifying changes in fair value recognized through other comprehensive income (“FV-OCI”) is overly complicated and will significantly increase the volume of information presented on the face of the financial statements;
- Credit Impairment Model - The proposed credit impairment model is complex, difficult to operationalize, and reduces comparability across entities’ financial statements;
- Interest Income Recognition Model - The proposed interest income recognition model reduces transparency of economic returns and credit performance and entails significant operational complexity;
- Deferred Tax Assets - The evaluation of the deferred tax assets (“DTA”) related to amounts recognized in other comprehensive income (“OCI”) along with all other DTA for a valuation allowance perpetuates a conceptual inconsistency with respect to the recognition of the DTA;
- Derivatives and Hedging - The proposed guidance for de-designation of hedging relationships and accounting for hybrid financial instruments may increase operational complexity and costs without sufficient corresponding benefits. Additionally, the guidance for derivatives does not address income statement presentation for the interest component of certain types of interest rate derivatives; and
- Other Matters - Many of the proposed Update’s detailed interactions with existing U.S. GAAP for financial instruments are not clear.

These concerns are discussed in greater detail below.

Convergence with IFRS

Though the proposed Update is part of a joint project between the Board and the International Accounting Standards Board (“IASB”) with the objective of developing converged accounting

guidance for financial instruments, we note that there are fundamental differences between the frameworks set forth in the proposed Update and in IFRS 9, *Financial Instruments* (“IFRS 9”), the IASB’s corollary project.

The conceptual differences include the subsequent measurement attribute for various financial instruments and the model for estimating and recording amounts related to credit impairments for financial assets. These are two of the “bedrock” issues of financial instruments accounting and differences in approach with respect to these issues between the Board and the IASB will magnify the lack of comparability of financial statements prepared under U.S. GAAP and those prepared under IFRS.

We note the proposed effective date for the guidance in the proposed Update is no sooner than January 1, 2013. This effective date, coupled with speculation that the acceptance of IFRS by the Securities and Exchange Commission (“SEC”) ¹ may come within a few years thereafter, suggests that the accounting framework in the proposed Update may be adopted and be followed, in a relatively short time period, by adoption of the IFRS 9 framework.

We believe the burden of adopting two such comprehensive and different accounting standards in such an abbreviated timeframe would be significant, both for preparers and users of financial statements. Therefore, we suggest that the Board consider what practical and prudent steps can be taken with respect to the proposed Update to align the U.S. GAAP financial instrument accounting framework with the IFRS 9 framework to help minimize the costs and potential confusion of migrating from one accounting framework to another in a short period of time.

Subsequent Measurement Attribute

The default measurement attribute for all financial instruments in the proposed Update is fair value although, in very narrow circumstances, the proposed Update permits the use of amortized cost for certain financial liabilities. As stated earlier, we believe that information about the fair value of financial instruments is relevant and useful; however, we do not believe that fair value is relevant as the measurement attribute in certain circumstances. When fair value is not relevant as the measurement attribute, we believe that fair value information should be provided as a disclosure in the footnotes to the financial statements.

As discussed in greater detail in our response to question 13 in Appendix A, we believe that the measurement attribute for financial instruments should be based on an entity’s business strategy related to those instruments. If an entity’s business strategy is to hold certain financial instruments for collection or payment of cash rather than to trade them for the realization for gains and losses, we believe amortized cost is the most appropriate measurement attribute for those instruments in the statement of financial position, with disclosure provided in the footnotes to the financial statements of the fair value of such financial instruments. If an entity’s business

¹ In the SEC’s *Commission Statement in Support of Convergence and Global Accounting Standards* dated March 2, 2010

strategy does not involve holding the financial instrument for collection or payment of cash, then we believe that fair value is the appropriate measurement attribute for that instrument. The conditions set forth in paragraph 21 of the proposed Update for permitted financial instruments to be measured at FV-OCI are better suited as the conditions for determining when amortized cost is the appropriate measurement attribute.

If the measurement attribute for financial instruments differs from an entity's business strategy related to those instruments, financial metrics would be distorted such that they are not representative of amounts that the entity expects to realize related to these instruments. We do not believe that the changes in fair value of financial instruments held by an entity for collection purposes should be included within the entity's reported measures of financial performance (in the statement of comprehensive income) and financial position because their inclusion would distort analysis of these financial statements.

For example, a majority of Freddie Mac's consolidated balance sheet consists of financial assets (mortgage loans) and financial liabilities (beneficial interests in the form of debt securities) held and issued by consolidated securitization trusts. With limited exceptions, Freddie Mac is legally restricted from taking actions with respect to these financial instruments other than collecting the payments on the mortgage loans and passing through such amounts to the holders of the associated beneficial interests. Freddie Mac is not permitted to sell or otherwise transfer these mortgage loans and, therefore, has limited ability to realize any revenue/income/value from fair value fluctuations in these financial assets. We note that a similar rationale supported the conclusion that participant loans in defined contribution pension plans be measured at amortized cost instead of fair value in EITF Issue No. 10-C, "Reporting Loans to Participants by Defined Contribution Pension Plans," which was recently ratified by the Board. Yet, under the model set forth in the proposed Update, Freddie Mac's comprehensive income would reflect the changes in the fair value of these instruments. Requiring the measurement of all financial instruments at fair value may fail to take into account management's business strategy for holding certain of those financial instruments, which we believe is an important consideration for users of financial statements as it impacts the assessment of the amounts, timing, and uncertainty of future cash flows². If the business strategy involves holding a financial instrument, such as loans to borrowers, for collection, changes in fair value do not provide useful information to users as the measurement attribute.

Furthermore, if the measurement attribute for a class of financial instruments is inconsistent with an entity's business strategy for those financial instruments, segment reporting will become disconnected from financial reporting. Because segment reporting is required to be based on the information that management uses to manage the business, assess performance and allocate resources, we believe that entities that hold financial instruments for collection may appropriately choose to use amortized cost as the measurement attribute in segment reporting, rather than fair value. While segment results must be reconciled with U.S. GAAP-based

² We note that the Board has advocated such a "business strategy approach" in paragraph BC26 of the recently-issued Proposed Accounting Standards Update—*Fair Value Measurements and Disclosures* (Topic 820) and believe a similar approach should be employed in the proposed Update.

financial reporting, we believe the relevance of the U.S. GAAP-based financial statements may be diminished if segment results and GAAP results are based on different measure attributes. We believe it is more difficult for users of financial statements to understand segment results that are not based on the same measurement attribute as the U.S. GAAP-based financial statements.

Lastly, requiring all financial instruments to be measured at fair value may not change the information presented in earnings press releases or accelerate the release of fair value information to investors. Given there are no specific requirements on the content of information to be included in an earnings press release, mandating fair value as the measurement attribute may not have the intended effect of providing this information to users more rapidly. Also, fair value information for disclosures in the footnotes to the financial statements is typically among the last information to be obtained prior to release of the financial statements. We believe that mandating fair value as the measurement attribute for all financial instruments may have the unintended consequence of delaying the release of information to users, as entities obtain fair value information and consume it through accounting and internal control processes.

Financial Statement Presentation

For financial instruments measured at FV-OCI, the proposed Update requires a very complex financial statement presentation. Even though the measurement attribute for these instruments is fair value, the proposed Update requires presentation on the face of the statement of financial position of 1) amortized cost, 2) the allowance for credit losses, 3) the calculated difference between amortized cost less the allowance for credit losses and fair value, and 4) the actual fair value. Presentation of the different measurement attributes and components needed to reconcile amortized cost to fair value on the face of the balance sheet for each class of financial instrument measured at FV-OCI will significantly increase the volume of information on the balance sheet, likely increasing the length of the balance sheet beyond a single page. We believe the resulting balance sheet will be confusing, as multiple measurement attributes will be displayed, and the comparisons between periods will be complicated due to the differences between these measurement attributes (i.e., an amortization attribute, which is based on collection of cash flows, and a fair value attribute, which includes components such as risk premiums, liquidity premiums, and life of asset expected credit losses using forecasted information, etc.).

The income statement will also be difficult to understand, as the income effect from credit risk will be recognized in multiple places in line items that are based on different measurement attributes (i.e., in interest income, provision for credit losses, fair value gains and losses, and other comprehensive income gains and losses). We believe this loss of transparency into credit risk would be extremely complicated for users of financial statements to evaluate.

Under the proposed Update, the statement of cash flows will have significant non-cash activity that must be added back to net income to derive the cash flow from operations, or disclosed as non-cash investing and financing activities. Further, it is not clear whether the statement of cash flows should be disclosing only the changes in the fair values of the financial instruments measured at FV-OCI, or whether it should reflect the activity of the component parts disclosed

on the face of the balance sheet (i.e., amortized cost, allowance for credit losses, and the calculated difference between amortized cost less the allowance for credit losses and fair value).

Lastly, as discussed in our response to question 65 in Appendix A, the proposed Update does not adequately address how footnote disclosures for financial instruments measured at FV-OCI should be presented. For example, it is not clear what measurement attribute should be disclosed for loans and the related allowance for credit losses. Further, it is not clear why disclosures related to amortized cost and an allowance for credit losses would be relevant if the measurement attribute is fair value. If however, the amortized cost-based disclosures are retained, the proposed Update does not address how such disclosures will be reconciled with the fair value measurement attribute reflected on the face of the financial statements, which will result in a disconnect between the financial statements and the footnotes that we believe will be confusing to users. For investment securities, existing disclosure requirements do not contemplate the presentation of amortized cost and an allowance for credit losses. The proposed Update does not address whether the disclosures currently required for investment securities classified as available-for-sale will apply to those measured at FV-OCI, or whether new disclosures will be required. We encourage the Board to conduct a thorough evaluation of the disclosure requirements for all financial instruments and compare them with the measurement requirements for financial instruments in the proposed Update, and provide a complete package of disclosures related to the various classes of instruments. Absent such guidance, we believe there will be significant diversity in practice that will render comparison of financial statements between entities extremely difficult.

Credit Impairment Model

The current credit impairment model recognizes credit impairment when it is probable that a loss has been incurred based on events and conditions existing as of a financial reporting date (i.e., the incurred loss model). The model in the proposed Update eliminates one key provision (the probability threshold) of the incurred loss model and retains another (the inability to employ a forecast of future events or economic conditions in determining impairments). The resulting credit impairment model thus mixes elements of the incurred loss model and an expected loss model. We believe it is difficult to mix the two concepts and achieve a coherent credit impairment model that is both operational and comparable across entities.

As discussed in our response to question 38 in Appendix A, we agree that the removal of the “probable” threshold for credit impairment will likely result in earlier recognition of credit impairments; however, we do not believe the credit impairment model in the proposed Update will be operational and may not produce comparable results unless the threshold is replaced with a principle that is clearly understood by preparers, users, and auditors. The absence of a clear principle may lead to additional diversity in practice due to varying interpretations of when to record credit impairments (i.e., ranging anywhere from “remote” to “possible”). This diversity in practice would result in decreased transparency in the credit impairment estimation process and reduced comparability between entities’ financial statements. Further, in the absence of a clear principle, it is possible that entities may interpret the model to suggest that an immediate

loss would be recognized at the origination of a new loan or the purchase of a new investment security that is measured at FV-OCI, despite the fact that the instrument was just underwritten and priced for the credit risk inherent in the asset.

We do not agree that the credit impairment assessment should exclude forecasts of future events or economic conditions. Excluding these forecasts is inconsistent with how we manage credit (i.e., consideration of these future events in planning, forecasts, consideration of loss mitigation strategies and alternatives, etc.). The rationale provided for excluding the forecast of future events is the lack of precision of these estimates. These very same forecasts would be considered in a fair value measurement. We do not understand how these forecasts lack precision within the context of credit impairments, yet are precise enough for a fair value measurement.

As an alternative to both the model described in the proposed Update and the model proposed by the IASB, we recommend that the Board consider lowering the current threshold for recognition of impairment from ‘probable’ to ‘more likely than not,’ and permit forecasts of future events and economic conditions (i.e., implied forward interest rate yield curves, forward home price forecasts, etc.). While this alternative approach is still essentially an incurred loss model, we believe it achieves the objective of the proposed Update (e.g., recognizing losses earlier), without an entirely new model that introduces significant complexity.

Interest Income Recognition Model

We do not support the interest income recognition model described in the proposed Update. We do not agree with 1) the reduction of interest income for credit losses, 2) the different method of recognizing transaction fees and costs between financial instruments measured at fair value with changes in fair value recognized through net income (“FV-NI”) and those measured at FV-OCI, and 3) the non-accrual provisions. Additionally, we believe there will be significant operational challenges to implement the interest income recognition model in the proposed Update.

Reduction of interest income for credit losses

As described in greater detail in our response to question 48 in Appendix A, from a conceptual perspective, we are concerned that the proposed interest income recognition model may produce financial results that do not reflect the economic substance of a business and that this model seems to contradict the recommendations made by the SEC’s Advisory Committee on Improvements to Financial Reporting in its 2008 report³ that standard-setting should seek “to capture the economic substance of transactions to the extent feasible.”⁴ Financial instruments are priced based on the risks inherent in the instrument at origination (e.g., the interest rate on a

³ *Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission* dated August 1, 2008

⁴ Please refer to “Recommendation 2.6” and the associated discussion in this report for the discussion leading up to this recommendation

loan). The interest recognized on these financial instruments is expected to reflect this risk (i.e., higher risk assets would be expected to have higher interest rates than lower risk assets). Reducing interest income for the credit risk of the asset obscures the returns, and makes comparison of entities complicated, as the risk profile differences will not be readily apparent between entities.

The proposed Update requires that the difference between actual cash interest received on the financial asset and the interest income recognized be recognized as an increase in the allowance for credit losses. Recognition of an allowance without a corresponding charge to earnings significantly complicates the rollforward of the allowance for credit losses, and impedes understanding of how this amount changed during a reporting period. If credit has not deteriorated and additional reserves are not needed during the period of collection of excess interest, the excess allowance will be reversed against the provision for credit losses through net income. This further complicates the rollforward of the allowance, as it is possible for an entity to actually show a negative provision during certain periods (i.e., income). Further, we observe that certain of the requirements of the proposed Update do not permit recognition of the benefit of credit enhancements in the allowance (i.e., requiring a gross presentation), yet the interest income model of the proposed Update requires net presentation of components of interest and credit. We do not understand how this combination of credit and interest components yields an incremental improvement to financial reporting.

As a result, we believe users of financial statements will have greater difficulty analyzing and understanding the results of entities as they will have to evaluate information in the footnotes to the financial statements to understand the interplay between net interest income, allowance for credit losses, the provision for credit losses, and actual cash collections versus recognized interest income.

We believe that users of financial statements are best served by providing interest income amounts that are representative of cash returns and credit loss amounts based on the net principal amounts an entity expects to lose (i.e., the loss of principal net of expected recoveries from the sale or collection of collateral and credit enhancements). To the extent that interest returns or credit losses are volatile (i.e., interest is not expected to be collected, thereby negatively impacting interest income, or an increase in credit losses is incurred), we believe that the financial statements should reflect this volatility, as it is indicative of the economic volatility experienced.

Transaction fees and costs for FV-NI and FV-OCI

As we articulated in our response to question 11 in Appendix A, we do not agree with the requirements of the proposed Update to expense transaction fees and costs for financial instruments measured at FV-NI, but defer and amortize these fees and costs for financial instruments measured at FV-OCI. Net interest margin (“NIM”) is an important metric for financial institutions, so we believe that interest income should be recognized consistently, regardless of where the change in fair value is recognized on the statement of comprehensive income (i.e., in net income or in OCI).

Non-accrual provisions

As discussed in our response to question 48 in Appendix A, we do not support the non-accrual provisions of the proposed Update. To determine whether a financial asset has a negative yield, it is not clear whether the asset's original principal described in the test is inclusive of amortization and previously recognized impairments. If such amounts are included, we do not understand how non-accrual would ever apply. If amortization is not included, we would expect that, over time, an increasing number of financial assets will meet the test for the application of non-accrual, simply due to the mechanics of the test, due to the fact that recognition of revenue is not appropriate as it is not expected to be collected.

When there is substantial doubt as to collectability of a loan in accordance with its contractual terms, we believe it is appropriate to discontinue the recognition of interest income. We do not believe financial reporting is improved by reducing current period income for credit losses, which has the effect of reducing current period interest income for loans where collectability is expected to be in question in the future – essentially smoothing income. Rather than mandating wholesale changes to a model that is currently understood, it is our opinion that the Board should consider adopting targeted enhancements to the application of non-accrual provisions. For example, guidance on the appropriate accounting treatment for accrued but uncollected interest as either an allowance for estimated uncollectible amounts or reversed against current period interest income would increase transparency and comparability across entities for users of financial statements while simplifying the burdens placed on preparers of financial statements.

As stated above, we believe the financial statements should reflect the actual economic volatility of an entity's financial instruments. We believe this provides users with more transparent information about the timing of cash flows and economic performance, and has greater predictive value of future performance.

Operational challenges

In addition to our conceptual observations, we foresee significant operational issues across the financial services industry arising as a result of implementing this framework. We described this in greater detail in our response to question 48 in Appendix A. Our preliminary assessment is that the systems integration, modification and/or development likely to be required to implement the interest income model in the proposed Update would require significant cost and effort. The most significant operational challenges in implementing the interest income model in the proposed Update will be the linkage of contractual accounting systems (e.g., those that perform amortization and accrue contractual interest) with credit and risk systems (e.g., those that assess and measure impairment), and dealing with the difference in the unit of account (i.e., asset level for accounting, pool level for credit impairments, and loan level for interest income, yet taking into account the pool level credit losses to derive the loan level interest income). A significant overhaul of our current systems, processes, procedures and controls would need to be planned, designed, implemented, tested and executed as our contractual accounting data and risk and credit data are currently housed in a number of different systems.

Deferred Tax Assets

The proposed Update requires that the DTA related to amounts recognized in OCI be evaluated together with all other DTA balances for a valuation allowance. As discussed in greater detail to our response to question 20 in Appendix A, we believe this aspect of the proposed Update highlights what is, in our opinion, an existing conceptual inconsistency with respect to the recognition of DTA under Topic 740 (*Income Taxes*). The DTA created by unrealized losses in OCI represents amounts that were never recognized in net income or taxable income, so they do not represent a temporary difference that will reverse in future periods, as is the case for other DTA. We believe this conceptual inconsistency would be overcome if entities were required to evaluate the DTA related to unrealized losses recognized in OCI for a valuation allowance (based on whether such losses are expected to reverse) separately from the evaluation of the DTA created by other items that were recognized in either net income or taxable income. We encourage the Board to reconsider the requirement to evaluate the DTA associated with amounts recognized in OCI along with all other DTA, or as an alternative, consider revising the recognition criteria for the DTA stemming from amounts recognized in OCI as required by Topic 740.

Derivatives and Hedging

We have three specific concerns related to the guidance in the proposed Update for derivatives and hedging activities: 1) the limitations for de-designation of hedging relationships, 2) accounting for hybrid financial instruments, and 3) income statement presentation for derivatives with an interest element.

De-designation of hedging relationships

The proposed Update states that an entity may not remove the designation of an effective hedging relationship unless the qualifying criteria for designating the hedging relationship are no longer met, or the derivative is terminated, sold, or exercised. For entities that engage in active hedging programs of pools of assets or liabilities that change on a regular basis, the ability to de-designate and re-designate the hedge relationship is a practical and efficient way to deal with the ever-changing pool that comprises the hedged item. Under the proposed Update, this approach would not be available. Instead, to achieve the same hedging effect, an entity would have to terminate existing derivative instruments, enter into new derivatives and designate the new pool of hedged items, which will cause the entity to incur additional cost. As discussed in greater detail in our response to question 63 in Appendix A, we are concerned that the increase in operational complexity and cost brought about by this change will not provide users of financial statements with benefits commensurate with those costs. We also note that the ability to voluntarily de-designate a hedging relationship has not been widely cited as being responsible for the complexity associated with hedge accounting, nor do we believe it to be a tool for earnings management or other nefarious purposes (as subsequent changes in value of the derivatives are difficult to predict).

Accounting for hybrid financial instruments

The requirement to account for hybrid financial instruments that contain embedded derivatives that would otherwise require bifurcation as a single instrument introduces operational complexity and may result in unnecessary income statement volatility. The existing embedded derivative rules occasionally require bifurcation of derivatives with little to no value (i.e., because under situations believed to be remote, the embedded derivative has the potential to double the investor's initial rate of return on the host instrument and double the then current market rate of return on the instrument – commonly referred to as the “double-double” test). We do not believe financial reporting is improved when a hybrid financial instrument containing such an embedded derivative results in the entire instrument being carried at fair value with changes in fair value recognized in earnings. Instead, we believe that the Board should consider clarifying the criteria for bifurcation of embedded derivatives to resolve the issues caused by the double-double test, as well as continue to permit bifurcation of embedded derivatives from host contracts.

Income statement presentation for derivatives with an interest element

While the proposed Update addresses interest income recognition for interest bearing financial assets (i.e., investment securities and loans), it does not address the income statement presentation of the interest component of certain types of derivatives (i.e., interest rate swaps). Freddie Mac, like many financial institutions, manages interest rate risk by looking at the net position of all interest-bearing financial assets and financial liabilities. We use a variety of interest rate-based derivatives to manage our net interest rate exposure. Management evaluates the economic performance of this risk management activity by including the interest component of the derivatives in NIM, while the unrealized gains and losses are considered as a separate component of net income when calculating and presenting segment earnings. We encourage the Board to consider permitting the interest portion of derivatives to be presented within NIM, while unrealized gains and losses would continue to be presented outside of NIM. We believe this will result in income statement presentation that is consistent with our economic decisions, which will be more useful for users of our financial statements. Additionally, such a change would lead to further convergence with IFRS as this treatment is acceptable under IAS 39, *Financial Instruments: Recognition and Measurement*.

Other Matters

Apart from the questions asked of respondents in the proposed Update and the language contained in that document itself, we believe many questions still remain as to how the comprehensive guidance set forth in the proposed Update will interact with the body of existing U.S. GAAP authoritative accounting literature for financial instruments, much of which is detailed and specific to only certain types of financial instruments. We suggest the Board consider providing more detail on how the proposed Update will interact with other financial instrument literature in an attempt to help affected parties assess the potential impact of the proposed Update. For example, it is not clear if the disclosure requirements set forth in the

proposed Update are intended to augment those currently required by other financial instrument literature such as Topic 320 and Topic 815 or replace them altogether. Another example, as noted in our response to Question 1 in Appendix A, is that it is not clear if the guidance in Topic 460 (*Guarantees*) is effectively superseded by the proposed Update or just amended by it, nor is it clear how the scope of the proposed Update interacts with the scope of the Board's current project on Insurance Contracts as it relates to financial guarantees. Further, since the proposed Update does not include proposed amendments to the Codification, it is possible that on review of these updates to the Codification we may have additional comments.

* * * * *

Appendix A contains Freddie Mac's responses to each of the individual questions posed by the Board in the proposed Update. Those responses provide additional discussion and context for the observations expressed in this letter.

Freddie Mac appreciates the opportunity to provide our comments on the proposed Update. If you have any questions about our comments, please contact Timothy Kviz (703-714-3800).

Sincerely,



Robert D. Mailloux
Senior Vice President - Corporate Controller and Principal Accounting Officer

cc: Mr. Charles E. Haldeman, Jr., Chief Executive Officer
Mr. Ross J. Kari, Executive Vice President - Chief Financial Officer
Mr. Christopher S. Lynch, Freddie Mac Audit Committee Chairman
Ms. Wanda I. DeLeo, Senior Associate Director and Chief Accountant, Federal Housing Finance Agency

Appendix A

This Appendix includes the specific questions that are relevant to Freddie Mac that were raised by the Board in the proposed Update, with our responses and comments. Questions not relevant to Freddie Mac have been excluded from this Appendix.

Scope

Questions for All Respondents

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

Response: Overall, we agree with the scope of instruments the Board has included in the proposed Update. However, we have the following observations pertaining to the scope of the proposed Update that the Board may wish to consider:

- We suggest the Board consider being more explicit in how the scope of the proposed Update interacts with other financial instrument literature. For example, guarantee contracts within the scope of Topic 460 (*Guarantees*) appear to be scoped into the proposed Update and would therefore be measured at fair value. However, it is not clear whether the proposed Update is meant to supersede the scope and accounting guidance of Topic 460 (or, for that matter, the scope of Topic 815 (*Derivatives and Hedging*)), or whether the scope exceptions contained in Topics 460 and 815 are still applicable.
- It is not clear to us what “*an interest in a consolidated variable interest entity*,” as set forth in paragraph 4(h) of the proposed Update, is intended to represent. Interests held in a variable interest entity that is consolidated would typically be eliminated in consolidation, so it is not clear what is intended by this paragraph.
- We suggest that the Board reconsider the scope exceptions for loan commitments or letters of credit held by a potential borrower in paragraph 4(j) of the proposed Update. Exclusion of these instruments will create an unnecessary accounting asymmetry between the holder and the issuer. We believe these instruments should only be excluded from the scope of the proposed Update if deriving the fair value of the instrument is not practical, and this exclusion should be available to both the issuer and the holder.
- In response to the instruments scoped out of the proposed Update in paragraph 5, it is not clear to us why the Board continues to scope out forward contracts related to regular-way security trades (paragraph 5(a)). As the Board is considering the broad overhaul of financial instruments accounting, we suggest that the Board also reconsider these scope exemptions, which have not been revisited holistically since the adoption of Topic 815 in its original form.

- The Board may want to consider whether the elimination of the fair value option for financial instruments in Subtopic 825-10 (*Financial Instruments>Overall*), and for hybrid instruments with embedded derivatives requiring bifurcation in Section 25 to Subtopic 815-15 (*Derivatives and Hedging>Embedded Derivatives>Recognition*) brought about by the proposed Update, would provide sufficient reason to address the fair value option available for servicing rights in Section 35 to Subtopic 860-50 (*Transfers and Servicing>Servicing Assets and Liabilities>Subsequent Measurement*). We note that servicing rights are not financial instruments; however, they are similar in nature to financial instruments and the existing accounting framework for these instruments is similar to the guidance being amended by the proposed Update.

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?

Response: No. We do not believe loan commitments related to revolving lines of credit issued under credit card arrangements should be excluded from the scope of the proposed Update, based on a similar rationale to our observation in our response to Question 1 regarding loan commitments or letters of credit held by a potential borrower.

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?

Response: We agree with the proposed Update's change to Topic 323 (*Investments – Equity Method and Joint Ventures*), but would suggest that further clarification of the Board's rationale be added. The only rationale given (found in paragraph BC25 of the proposed Update) is the Board's belief regarding circumstances in which the fair value option election was chosen in practice for equity method investments. This reason, in isolation, does not seem to provide the conceptual basis for the proposed change to a long-standing accounting principle.

Initial Measurement

Questions for All Respondents

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

Response: No, we do not agree with the initial measurement criteria for the different classifications of financial instruments in the proposed Update. We believe the initial

measurement principle for all financial instruments should be fair value. We believe that financial instruments measured at fair value with changes in fair value recorded in net income (“FV-NI”) should be required to undergo the same ”transaction price” versus ”fair value” comparison mandated for financial instruments measured at fair value with qualifying changes in fair value recorded in other comprehensive income (“FV-OCI”) in paragraphs 14-17 of the proposed Update, as any difference in these amounts may be due to unstated rights or privileges that warrant consideration under other U.S. GAAP instead of immediate recognition in net income.

We believe there is an assumption in practice that the transaction price is indicative of fair value, unless there is evidence to call this presumption into doubt. When such doubt exists, entities should consider the facts and circumstances to determine the reason for that difference and apply other U.S. GAAP to any other elements of the transaction as necessary. Topic 820 (*Fair Value Measurements and Disclosures*) already provides guidance on determining whether the transaction price is indicative of fair value and we believe the Board could leverage this existing guidance in helping constituents implement an initial measurement principle related to situations in which the transaction price is not assumed to equal fair value.

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?

Response: No, we do not agree. It is our opinion that this guidance could lead to a significant number of situations in which an entity would record “day 1” gains or losses in earnings upon recognition of a financial instrument. These day 1 gains and losses would not necessarily be evidenced by an exchange of cash, and they would subsequently be amortized into interest income. We struggle with the usefulness of recognizing a day 1 non-cash gain or loss that will then be amortized back into earnings, since both the day 1 and day 2 recognition would not be evidenced by actual cash flow and would not produce information that is of predictive value.

We experienced similar accounting effects in the past with our guarantee accounting, under which we previously recognized and subsequently amortized certain day 1 differences. The effects of this accounting tended to disconnect reported financial results from management of the business and the underlying cash flows. This disconnect made it difficult for users of our financial statements to understand the business and the underlying cash flows.

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?

Response: Yes, as discussed in our response to Question 8 above, we believe there should be a single initial measurement attribute for all financial instruments, which would be fair value. Also, [as noted in our comment letter, part of our concern is that the initial measurement principle set forth in the proposed Update impacts the recognition of net interest margin in subsequent periods, which we believe is an important operating metric for a financial institution, and could result in financial reporting results under U.S. GAAP becoming less aligned with the economic return on financial instruments viewed from the perspective of the underlying business unit. Therefore, we believe any initial measurement principle should also consider the “day 2” subsequent measurement and accounting.

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?

Response: We believe eligible transaction fees and costs should be deferred and amortized as an adjustment of the yield for both FV-NI and FV-OCI, as different treatment of these items will cause corresponding net interest margin differences. We share the Board’s observation in paragraph BC202 of the proposed Update that users of financial statements place significant value on reported net interest margin and believe the Board should strive for consistency across financial instruments in this regard.

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?

Response: Yes, we believe that the proposed guidance is operational as it builds upon the assessment currently required by the provisions of Topic 820, which have been in place for several years.

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?

Response: We do not believe that fair value should be the default measurement attribute for all financial instruments. Instead, we believe that the measurement should be based on management's business strategy.

Importance of Management's Business Strategy

Although the proposed Update does consider an entity's business strategy in determining whether a financial instrument will be measured at fair value with changes in fair value recorded in net income or with qualifying changes in fair value recorded in other comprehensive income, we believe that a financial instrument's measurement attribute (i.e., fair value or amortized cost) should be predicated upon the reporting entity's business strategy for that instrument. Investors and other financial statement users need information that provides insight into how an entity is managed and how its financial performance is predictive of future operating results. When financial statements do not reflect management's business strategy, they are less useful to investors and other users. Information about an entity's business strategy has strong predictive value since management is responsible for the day-to-day and strategic operations of an entity and management's decisions have a direct impact on the entity's operating performance and cash flows realized.

We note that a study conducted by PricewaterhouseCoopers LLP¹ of investment professionals found that a large majority of the participants noted that an entity's business model should be of primary consideration in the determination of the balance sheet classification and measurement of a financial instrument. We believe that an amortized cost approach would provide a better representation of an entity's business model when the business model is primarily to hold financial instruments for collection or payment.

Interaction with Segment Reporting

Topic 280 (*Segment Reporting*) requires that segment results be presented based on how an entity's business is managed. If an entity's business strategy is to hold financial assets for collection or liabilities for repayment, segment results might be required to be presented based on the amortized cost measurement attribute. The guidance in the proposed Update would result in a disconnect between U.S. GAAP results and segment reporting. Preparers of financial statements would need to "bridge this gap" in their segment disclosures. This will increase operational complexity, complicate the financial statements, and produce unintended consequences for management and users of the financial statements. For example, if performance is assessed based on segment reporting results that are based on an amortized cost measurement attribute, we believe that users of the financial statements prepared using a fair value measurement attribute may find it difficult to understand how management and corporate performance was assessed and factored into resource allocation and performance-related

¹ *What Investment Professionals say about Financial Instrument Reporting*, published in June 2010

decisions due to the disconnect between these two measurement attributes. Also, large reconciliations between segment results to U.S. GAAP results may dilute the value of U.S. GAAP results since it would less often reflect how management runs, measures and monitors a business.

Relevant Measurement Attribute by Business Strategy

We believe that fair value is the appropriate and most relevant measurement attribute for financial instruments that an entity does not hold for the collection or payment of contractual cash flows. Instruments held for trading or to profit from shorter-term market movements should be measured on a fair value basis, as the periodic fluctuations in fair value have predictive value in terms of future amounts likely to be ultimately realized by the entity.

Conversely, when an entity intends to hold financial instruments for collection or payment of contractual cash flows, we believe an amortized cost measurement attribute (less an appropriate valuation allowance for financial assets) is more appropriate and provides more decision-useful information to investors and other users of financial statements. We believe that the conditions set forth in paragraph 21 of the proposed Update (i.e., the criteria to identify those financial instruments that are held for collection or payment that would be measured at FV-OCI under the current form of the proposed Update) provide a reasonable method of identifying those financial instruments which could be measured at amortized cost. For these financial instruments, we believe that fair value information is useful as a disclosure item, but not as the primary measurement attribute.

Impacts of Changes in Fair Value on Reported Financial Statement Metrics

Inherent within the current accounting framework governing fair value measurement and disclosure (Topic 820) is the presumption that the instrument being valued is being disposed of as of the measurement date. If an entity holds a financial asset for collection of the contractual amounts due and issues a financial liability with the intent of remitting the contractual cash flows to the holders thereof – that is, the entity’s business model or strategy is to hold/maintain these instruments for the long term and not settle them prior to maturity – then fair value fluctuations (in both positive and negative directions) are not representative of amounts that the entity will realize related to these instruments². Therefore, for these entities, we do not believe that measurement at fair value provides the most decision-useful information for users of financial statements.

Under the proposed Update, financial instruments held or issued for the collection or payment of the contractual amounts are required to be measured at fair value, with fluctuations in fair value from the prior reporting period reflected in the statement of comprehensive income, the primary financial statement metric relating to an entity’s performance over a period of time. Thus, an entity’s operating performance will include fluctuations in the fair value of financial instruments

² The obvious exception to this point being changes in fair value due to credit losses on financial assets held, which should be reported as a component of net income.

that the entity, by design of its business model, is unlikely to realize. Likewise, the reporting date fair value of such instruments will be reflected in an entity's statement of financial position, a key measure of the entity's financial health as of a specified point in time, even though such amounts have limited predictive value of the future cash flows the entity is likely to realize over subsequent periods. We believe this detracts from the usefulness of an entity's reported comprehensive income and equity as noted in the discussion of alternative views found in paragraph BC246 of the proposed Update.

For financial assets and liabilities held over their contractual lives, we believe the more salient information is the effective return earned and paid, respectively. In this regard, we concur that the objective of amortized cost measurement, as specified by the IASB, should be to provide information about the effective return of a financial instrument by allocating interest income or interest expense over the expected life of the instrument.

An objection has been raised that including the amortized cost measurement attribute in the accounting framework would result in a "mixed measurement" model that increases the complexity of reported information related to financial instruments. While it is certain that a mixed measurement model is created when both amortized cost and fair value are available measurement attributes, we do not believe such a model creates undue complexity in the information an entity discloses around its involvement with financial instruments.

We note that the comment letters received by the IASB in relation to the classification and measurement project within the overall IFRS 9, *Financial Instruments*, framework were almost unanimously supportive of a mixed measurement model. The most frequent reason cited by these respondents was that amortized cost measurement provided information about an entity's likely actual cash flows that fair value information did not provide due to the latter's presumption that the financial instrument is sold or settled on the measurement date. In the previously mentioned PricewaterhouseCoopers LLP study, a majority of the participants favored such a mixed measurement model for similar reasons.

It is our belief that the Board could achieve the objective espoused in the proposed Update by allowing a mixed measurement model as described in the preceding paragraphs and, concurrently, providing both credit quality and fair value information through footnote disclosure requirements. In the PricewaterhouseCoopers LLP study cited above, a significant majority of the respondents indicated they viewed information disclosed in the footnotes to be of equivalent quality to that presented in the primary financial statements. We believe this observation helps underscore that fair value does not need to be the primary measurement attribute to be informative to financial statement users.

As a result, we encourage the Board to consider aligning the measurement attribute for financial instruments with an entity's business strategy, and permit use of the amortized cost measurement attribute when an entity intends to hold financial instruments for collection or payment.

Primary Disadvantages of Amortized Cost Measurement Attribute

In paragraph BC78 of the proposed Update, the Board noted what they believed to be the primary perceived disadvantages of amortized cost:

- Amortized cost reflects a historical transaction price that is not relevant for current investment decisions.
- Under an amortized cost approach, an entity can change its intent and realize in net income short-term changes in value.
- The use of amortized cost necessitates the development and application of complex impairment models, which could create opportunities to smooth the recognition of income.
- Complex tainting rules may be necessary if some instruments are measured at amortized cost and others measured at fair value with management's intentions used as the basis for categorization between the two.

We agree with the Board that these observations are disadvantages of the amortized cost model. However, we believe that these disadvantages can be mitigated through disclosures rather than requiring the measurement of all financial instruments at fair value.

In response to the first disadvantage, that amortized cost information is "stale" and not useful for current investment decisions, we note that amortized cost information has been cited by financial statement users as providing predictive value with regard to the future cash flows of an entity. This predictive value makes amortized cost information a measure of significant relevancy in making current investment decisions. We also note that providing fair value information through increased disclosure can address concerns that may arise from the use of amortized cost information.

Both the second and fourth disadvantages cited above specifically deal with the impact of management intentions on the classification of financial instruments, which are often subjective. We agree that the usage of management intent as a "lever" to change measurement attributes will inherently open the door for some measure of selective changes in intent. However, we do not believe this is an insurmountable disadvantage to the use of the amortized cost measurement attribute. As noted in more detail in our response to Question 16 below, we believe the concern over the issue of management intentions could be assuaged by requiring changes in measurement attributes when an entity's business model changes, similar to that set out in IFRS 9. Therefore, a change in measurement attributes would only arise upon a change in business model, as opposed to an instrument-specific change in management intent.

The third of the Board's observed disadvantages of an amortized cost measurement attribute is that it necessitates the use of impairment models requiring significant management judgment and interpretation which could be subjective at best and, at worst, able to be manipulated to smooth earnings. This is, in our opinion, the primary shortcoming of an amortized cost measurement

attribute. However, as the Board and the IASB have discovered in their recent standard-setting activities, this issue is endemic across all financial asset classifications that do not require all changes in fair value to be recorded in net income. It is therefore, not limited to those financial assets measured at amortized cost. Further, application of the proposed Update could itself have the effect of smoothing earnings by, for example, requiring recognition of day 1 gains or losses, so that a market yield is always recognized on interest earning assets and liabilities (rather than the actual yield reflective of the investment decisions made by management), or through the income recognition criteria which results in a reduction to the amount of recognized interest income only to build the allowance for credit losses.

Contribution to ultimate convergence with IFRS

The inclusion of the amortized cost measurement attribute will eliminate one of the larger conceptual and presentation differences between the accounting models set forth in the proposed Update with the measurement principles contained in IFRS 9. In eliminating this difference, the Board can provide a stronger platform for the ultimate convergence of the U.S. GAAP accounting model for financial instruments and that of the IASB.

Presentation Matters

We understand the Board's desire to provide investors and users with fair value information on a timely basis and applaud this effort. However, we believe it would be preferable if entities were able to respond to requests for such information from the investing public and analysts on an individual basis, rather than through the setting of accounting standards that apply to all entities. Fair value information is not decision-useful for all entities and has varying levels of relevance depending on the enterprise, so to mandate it for all enterprises is not optimal. Further, practice varies as to the specific information that entities choose to provide in earnings releases that may precede the issuance of the complete financial statements, including the footnotes. Finally, entities may not issue a complete statement of financial position in their earnings releases, so amortized cost and fair value measurement attributes may not be released when the earnings release is issued.

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?

Response: We do not believe there are any other fair value changes that should be recognized in net income. However, as stated in our response to question 13, we believe the Board should consider expansion of the amortized cost measurement attribute to financial instruments that an entity intends to hold for collection or payment.

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

Response: Yes, we believe that subsequent measurement principles should be consistent across both financial assets and financial liabilities. Additionally, as noted in further detail in our responses to Question 13 and Question 16 herein, we believe that the subsequent measurement attribute for financial instruments should be predicated upon management's intent or business strategy so that the resulting measurement attributes are reflective of any entity's business model and provide useful information that has predictive value to financial statement users.

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?

Response: We do not agree with the prohibition in the proposed Update on reclassifications of financial instruments subsequent to their initial recognition. We believe that an entity should retain the ability to reclassify financial instruments in specifically defined circumstances – namely if an entity's business model changes. We understand and acknowledge the Board's concerns regarding the ability of an entity to reclassify financial instruments in such a way or pattern as to maximize fair value increases and minimize fair value decreases being recognized in net income and share this concern with the Board.

However, we are concerned that an irrevocable initial classification decision will result in an accounting framework that places little informational value on management's current intent or business strategy with respect to financial instruments. The guidance in the proposed Update would only allow a change in business model or strategy to be reflected prospectively as new financial instruments are recognized. We do not believe this is representative of how institutions are actually managed. The existing accounting framework for loans and investment securities provides the ability to reclassify amongst measurement categories, so we believe preparers, auditors and users are sufficiently familiar with this concept to understand its impact on financial statements.

We note that, under the framework set forth in IFRS 9, reclassifications are **required** (versus merely being 'permitted') when an entity's business strategy changes. We share the view of investment professionals in the recent PricewaterhouseCoopers LLP study cited above that underscored the view that an entity's business strategy and/or intent is a necessary consideration in determining the classification of a financial instrument. We further believe that if an entity's business strategy is important for purposes of determining its initial classification, then there is symmetric conceptual merit to considering changes in this business strategy in the determination of a financial instrument's subsequent classification.

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?

Response: We agree that financial liabilities – and financial assets – should be eligible for measurement at amortized cost. Our response to Question 13 above provides our rationale and the suggested conditions for continuing this measurement attribute on a more expansive basis than the current wording of the proposed Update would allow.

If the Board proceeds with the proposed Update as currently worded, we would ask the Board to reconsider the conditions in which an “accounting mismatch” is deemed to be present as we are concerned that the proposed Update’s current wording represents more of a “bright-line” than a principle when it comes to the “quantitative tests” required in paragraphs 30(b) and 30(c) of the proposed Update.

Our interpretation of the “contractual linkage” condition in paragraph 30(a) is that the types of financial liabilities addressed would primarily include mortgages against real property (e.g., a loan secured by a building, machinery, land, etc.). We believe this condition is overly restrictive. We would suggest the Board consider adding to the accounting mismatch criteria the consideration of whether such mismatch would exist over the life of the financial liability.

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?

Response: We believe the Board has identified the correct type of financial instruments to make eligible for the redemption amount measurement attribute.

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?

Response: We do not agree that an entity should evaluate the need for a valuation allowance on a deferred tax asset (“DTA”) related to a debt instrument measured at FV-OCI in combination with other DTA balances of the entity. Rather, we believe that any DTA associated with a debt instrument classified as FV-OCI should be segregated and analyzed separately.

We believe that recognition of DTA related to a debt instrument measured at FV-OCI is conceptually flawed, since the unrealized losses recognized in OCI were never recognized in earnings or taxable income. Assessing the DTA associated with unrealized losses recognized in OCI separate and distinct from other DTA balances helps to overcome this flaw. If the

unrealized losses are expected to reverse and never be realized in net income or taxable income and an entity has both the intent and ability to hold the assets creating these unrealized losses in OCI until they reverse, there is no conceptual reason to recognize a valuation allowance associated with the DTA.

Further, we believe that a requirement to evaluate the need for a valuation allowance on a DTA related to a debt instrument classified as FV-OCI in combination with other DTA balances of the entity is conceptually at odds with the requirements set forth in the proposed Update for FV-OCI classification. Under the guidance in the proposed Update, a debt instrument may only be classified as FV-OCI if an entity's business strategy is to "collect...the related contractual cash flows rather than sell the financial asset." Any credit impairment on debt securities classified as FV-OCI is required to be recognized in net income. Therefore, the guidance in the proposed Update allows the changes in fair value due to contractual cash flows that are expected to be recovered to be deemed "unrealized" in that an entity is only required to recognize in net income future amounts the entity does not expect to collect. Said another way, the component of the change in fair value recorded in OCI is expected to be recovered from the future cash flows of the debt instrument and the entity has had to assert that its business strategy is specifically to hold that debt instrument for the collection of those cash flows. Thus, any DTA amount recognized in an interim period is related to future cash flows that are expected to be collected, which would result in the gradual "unwinding" of any DTA amount as the debt instrument approaches maturity.

We do not believe there is conceptual merit to assess (or record a valuation allowance against) a DTA balance that is ultimately expected to be reversed over time and that is not expected to be realized in net income or taxable income. To do otherwise would essentially result in another component of the fair value change of a debt instrument classified as FV-OCI being recorded in current period net income (i.e., in the form of a valuation allowance against a DTA balance) and then being reversed over subsequent periods. We do not believe this would result in financial reporting that is indicative of future cash inflows as the end result is establishing a "reserve" against an amount that is expected to be realized.

As an alternative, we would encourage the Board to reconsider whether a DTA should be recognized for unrealized losses recorded in OCI. Topic 740 (*Income Taxes*) defines a DTA as "the deferred tax consequences attributable to deductible temporary differences and carryforwards." The DTA associated with unrealized losses recorded in OCI are not attributable to deductible temporary differences or carryforwards. The unrealized losses have not been recognized in earnings or in taxable income, so they do not create a temporary difference, but rather are a by-product of the balance sheet approach to establishing deferred tax assets and liabilities prescribed in Topic 740. Since these unrealized losses do not meet the definition of a DTA, we suggest the Board address this issue by amending the guidance on recognition of deferred tax assets contained in Topic 740.

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?

Response: Yes; if the Board passes the proposed Update in its current form, we believe the criteria for recognizing qualifying changes in fair value in OCI are operational. We also note that the criteria in paragraphs 21(a)(3) and 21(c) are presently found in U.S. GAAP and should not present incremental implementation challenges in and of themselves.

As noted in our response to Question 13 above, we believe that some of the criteria for recognizing qualifying changes in fair value in OCI should instead be used to assess whether an instrument can be measured at amortized cost, consistent with the model set forth by the IASB in exposure draft ED/2009/12, *Financial Instruments: Amortized Cost and Impairment*.

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

Response: Yes, we believe that measuring an entity's own financial liabilities at fair value will be operational for the majority of companies and particularly for those not eligible for the delayed effective date. We believe that the preponderance of fair value disclosures required by Topic 820 has resulted in nearly all companies obtaining or developing the ability to derive the fair value of their own liabilities, including the adjustments necessary to incorporate their own credit standing. However, we believe that fair value as a measurement attribute, as opposed to a disclosure only item, will delay preparation of the financial statements and compress financial reporting preparation timelines, particularly for public companies. Fair value information is oftentimes the last information to be obtained, so if the measurement attribute is fair value, entities will need to delay closing the books to consume the fair value information in the books and records.

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

Response: No, we do not believe these criteria are operational. As noted in more detail in our response to Question 18 above, we have concerns that the "contractual linkage" condition in paragraph 30(a) of the proposed Update is overly restrictive and we believe the "quantitative" conditions set forth in paragraphs 30(b) and 30(c) are more "bright-line" guidance than principles to apply to specific fact patterns. Consider a situation in which a debt instrument is issued to finance a non-financial asset, but the lender requires the borrower to pledge financial assets as additional collateral. While the intent of the loan may be to finance a non-financial asset, the proposed criteria may be interpreted in a way that the liability would not qualify for the amortized cost measurement attribute due to the additional collateral pledged to the lender. As stated earlier, we believe that an entity's business model should be of primary consideration in determination of balance sheet classification and measurement of a financial instrument.

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?

Response: As discussed in our responses to Question 13 and Question 16 herein, we have conceptual concerns with the classification model set forth in the proposed Update and would recommend the Board introduce broader use of the amortized cost measurement attribute for financial assets and liabilities. If the Board ultimately decides to retain the classification and measurement model as described in the proposed Update, we believe that measurement of financial liabilities at fair value with changes in fair value due to changes in an entity's credit standing (with changes in the price of credit) to be recognized in other comprehensive income is a preferable alternative to measurement of financial liabilities at FV-NI. This measurement attribute is more sensible due to the economic nature of the changes in fair value as a result of changes in an entity's credit standing. Deterioration in an entity's credit standing decreases the fair value of a financial liability, which has an accretive impact to comprehensive income. Many observers have commented that this result is counterintuitive due to the fact that the entity's risk of non-performance has increased and does not make economic sense as an entity would have limited abilities, if any, to actually realize this "gain".

As an additional benefit, this measurement attribute would bring the proposed Update in closer alignment with the accounting model for financial instruments set forth by the IASB on this issue.

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.

Response: We believe it would be appropriate to retain both methods set out in the proposed Update for the determination of the change in fair value of a financial liability attributable to a change in the entity's credit standing. Method 1, which is based on the change in an entity's credit rating, may not be applicable to smaller, unrated companies and these companies will therefore have to default to Method 2 (which is based on the "price of credit"). Freddie Mac

does not anticipate any operational challenges in implementing Method 1. However, we realize that there is a relatively small universe of entities that would be able to utilize Method 1 due to the level of sophistication required. Therefore, we would expect that many smaller companies would have to default to using Method 2 and suggest the Board retain this method to ease the implementation burden on these entities.

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.

Response: We believe that it would be appropriate to look to other entities of similar size and credit standing within the industry to determine the "cost of debt financing" because it would be the most relevant and reliable indicator of the price of credit a comparable entity would likely incur.

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?

Response: We do not believe that the objective of the credit impairment model is clear. Paragraph 36 states the objective as follows (emphasis added):

"The objective of the guidance related to credit impairment is to establish a model for recognition and measurement of credit impairment of financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income on the basis of an entity's expectations about the collectibility of cash flows, including the determination of cash flows not expected to be collected. An entity's expectations about collectibility of cash flows shall include all available information relating to past events and existing conditions but shall not consider potential future events beyond the reporting date."

We would propose deleting the last sentence of the objective (bolded above). We believe this sentence contradicts the objective set out in the previous sentence. As stated in the first sentence of paragraph 36, the objective of the proposed credit impairment model is to "...establish a model for recognition and measurement of credit impairment...on the basis of an entity's expectation about the collectability of cash flows, including the determination of cash flows not expected to be collected." The inability to consider forecast future events or economic

conditions would limit our ability to properly determine our expectation about the collectability of cash flows. The following examples illustrate this concern:

- *Example 1: Hybrid adjustable-rate-mortgage with a teaser rate of 1% for the first year in an increasing interest rate environment*

Based on our interpretation of the proposed model, we would not be able to forecast interest rates in our credit impairment assessment. Under this example, increases in future interest rates would have a significant impact on the collectability of cash flows as certain borrowers would not be able to make the increased payments. If we have observable market data suggesting that the interest rates are anticipated to increase significantly in the future (e.g., implied forward interest rate curves), we believe this information should be used in determining the proper credit impairment amount.

- *Example 2: Spot home price index versus forward home price index*

Based on our interpretation of the proposed model, we would not be able to consider forecast future home prices. In other words, we would be required to use a “spot” home price index (derived using existing economic conditions) instead of a “forward” home price index (derived using expectations of future economic conditions) to determine the amount of the credit impairment. In an environment where home prices are expected to decrease, the amount of recognized credit impairment using a spot home price index would be too low. For example, at the beginning of the recent credit crisis, we would have been required to assume that home prices would continue to stay at their peak, although the market-based estimates would clearly have indicated a decreasing future trend. Ignoring a decreasing future trend delays the recognition of the credit impairment. The reverse is true in an environment where home prices are expected to increase. If there is observable market data on expected housing price movements that will directly impact our estimate of expected cash flows, we believe this information should be used in determining the proper credit impairment amount.

Additionally, we note that one of the concerns over the use of a model which allows an entity to forecast expected cash flows over the life of a financial asset or pool of financial assets (i.e., expected loss model) is the difficulty in accurately forecasting expected cash flows over the life of financial assets on the basis of forecasted future events. We believe this concern is inconsistent with the overall fair value measurement concept of this proposed Update, because the level of difficulty in accurately forecasting inputs related to fair value would be comparable to the level of difficulty in accurately forecasting inputs related to the credit impairment.

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?

Response: We do not agree with the timing proposed by either the Board or the IASB around the recognition of credit impairment. We believe the appropriate timing for impairment recognition varies depending on the impairment model. Under the incurred loss model, an entity should recognize the loss over the life of the financial instrument as the loss is incurred. Under the expected loss model, an entity should either recognize the credit impairment immediately or over a reasonable time period when the losses are anticipated to occur. The Board's proposed impairment model appears to mix the elements of an incurred and an expected loss model, which makes it difficult for us to determine the appropriate timing for recognition of impairment.

We do not agree with the IASB's proposal of recognizing the expected loss as a part of net interest margin as this would significantly change the way net interest margin is currently viewed and used. For financial institutions, users of the financial statements place a significant value upon reported net interest margin. Recording credit impairments as a reduction of interest income would distort reported net interest margin and the users would need to either find a way to separately calculate the net interest margin as calculated today or completely change the way the net interest margin is utilized in their analyses.

Further, this model is inconsistent with how instruments are priced. Higher risk assets carry a higher return (in the form of an increased yield), which is designed to compensate the holder for the additional risk of non-performance. Reducing this return, as reported through interest income, for the expectation of losses due to higher risk of non-performance could have the unintended consequences of smoothing income and obfuscating financial performance. Under this model, a risk-free asset with no expected credit losses and a higher risk asset with substantial credit losses could hypothetically both contribute similar amounts to an entity's reported interest income due to the reflection of expected credit losses in the calculation of this amount. Such a result would not necessarily reflect meaningfully the investment decisions made by management.

We do not believe the current interest income model is a point of confusion for financial statement users. We believe changes to the credit impairment model should be developed

independent of the current interest income model. For additional detail on our view of the Board's interest income model, please refer to our response to Question 48.

If the two boards are unable to together agree on an acceptable expected loss model, we would propose retaining the current incurred loss model with two revisions: (i) permit holders of financial assets to forecast future events (i.e., consider implied forward interest rate curves, forward house prices, etc.), and (ii) reduce the existing "probable" threshold to "more likely than not". The model set forth in the proposed Update contains fundamental flaws, as articulated in our letter and this appendix, which would be difficult to overcome. It would not be sensible to replace the current credit impairment model unless the proposed model eliminates the existing fundamental flaws. We do not believe the proposed model accomplishes these goals.

Incorporating the two revisions noted above to the current incurred loss model will enable the Board to issue a model that ensures a connection between credit losses recognized by an entity and those expected by market participants (by requiring forecasts of future events to be included in the credit loss estimation process) and accelerates the recognition of credit losses (by lowering the "probable" threshold). We believe that these proposed changes would, in addition to the incremental benefits noted, lead to a credit impairment model that is more operational than both the model proposed by the IASB and that proposed by the Board.

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?

Response: We agree that 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 should not in and of themselves give rise to credit impairment.

With that said, we believe that changes in expected prepayments and changes in a variable interest rate are intricately linked to the other factors contributing to the overall change in cash flows. Therefore, we believe paragraph 50, which states "*When changes in expected cash flows due to variable rates or prepayments cannot be separated from the overall decline in expected cash flows, an entity shall account for the entire decline in cash flows expected to be collected as a credit impairment.*" would generally be applicable to all financial assets with prepayment and variable interest rates features.

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?

Response: We believe a specific method should not be prescribed. With the general principles provided in the guidance, an entity should have the ability to develop an acceptable methodology that best reflects the entity's business and asset composition.

Additionally, it may be helpful for the Board to consider incorporating paragraph BC189 into paragraphs 58 and 59. We believe paragraphs 58 and 59 can be interpreted to be more prescriptive than intended when read independent of paragraph BC189. Paragraph 58 specifically states, “the entity shall develop historical loss rates.” Paragraph BC189 notes that the Board recognizes the established practice of using a formula approach for estimating losses and confirms that the proposed guidance would not change this approach. Incorporating this concept into the body of the proposed Update would eliminate the potential for varying interpretations.

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?

Response: If the general concepts of Subtopic 310-30 (*Receivables > Loans and Debt Securities Acquired with Deteriorated Credit Quality*) continue to exist under the new model, we agree that the expected increase in cash flows compared to the original expectation should not be immediately recognized in net income.

We would recommend that the Board eliminate the general concepts set forth in Subtopic 310-30 from this proposed Update. The existence of Subtopic 310-30’s accounting model may result in two different accounting treatments for two substantially identical loan portfolios. Consider the following example:

- On 1/1, entity A originates 100 loans with substantially identical loan characteristics (e.g., interest rate and borrower risk characteristics)
- On 3/31, entity A sells 50 of these loans to entity B
- As of 3/31, all 100 loans are not performing as expected due to an economic downturn that impacted the borrowers’ ability to make payments

Under this scenario, as of 3/31, entity B’s loans are required to be accounted for under Subtopic 310-30 while entity A’s loans will continue to be accounted for under other applicable accounting guidance. Under Subtopic 310-30, although entity A and entity B’s loan portfolios are substantially the same, entity B’s loans will have a lower allowance for credit losses and entity B’s ratio of reserves to non-performing loans will differ (possibly by a significant amount) from entity A’s. As a result, it would be difficult to compare the performance of the two entities based on the information reported in the financial statements.

In order to eliminate some of these concerns, we recommend that purchased loans be recorded at the borrower’s outstanding balance, net of an allowance for credit losses. While we acknowledge the flaw of recognizing an allowance for credit losses without a corresponding charge to the provision for credit losses in earnings, we believe that this can be overcome through transparent disclosure in the rollforward of the allowance for credit losses. This model will also result in recognition of interest income that is more consistent with the stated coupon

rate, as well as the actual cash collected from the borrower. Analysis of non-performing assets, reserve levels, and relevant ratios will become much easier to comprehend and compare across entities, and the operational complexity of the model in Subtopic 310-30 is eliminated.

One of the primary objectives of the proposed Update is reducing the complexity in accounting for financial instruments and retaining all of these models would be counterproductive to this objective. As discussed in the preceding paragraphs, Subtopic 310-30 is viewed as a complex model with numerous practice issues that is not easily comprehensible to financial statement users. Retaining this model while introducing additional nuances may serve to increase the complexity in accounting for financial instruments.

Lastly, IASB does not have an accounting model akin to Subtopic 310-30. In eliminating this difference, the Board can provide a stronger platform for the ultimate convergence of the U.S. GAAP accounting model for financial instruments and that of the IASB.

The proposed Update's change (or perceived change) in the threshold for a creditor's use of the fair value of collateral as the basis for the measurement of impairment may also contribute to additional complexity and practice issues. Under the proposed Update, a creditor shall measure impairment on the basis of the fair value of the collateral when foreclosure is "expected" to occur. Under current U.S. GAAP, this threshold is defined as "probable". As there is not any discussion in the basis for conclusions speaking to the Board's intention on changing this threshold, we suggest the Board consider clarifying their intention to lower this threshold, or, if that was not the intention, we suggest the Board consider retaining the current "probable" threshold employed under current U.S. GAAP.

Additionally, as it pertains to measuring credit impairment when foreclosure is "expected" to occur, we suggest the Board consider clarifying whether estimated costs to sell the collateral should be included in that measurement. Under the proposed Update, guidance on this topic is only specifically provided for collateral-dependent assets using the practical expedient.

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?

Response: We do not agree with this requirement for the following reasons:

- When a financial asset is evaluated for impairment on an individual basis, information specific to that asset is used to determine if impairment is necessary. The requirement in the proposed Update seems to suggest that if there is no impairment based on the information specific to that asset, generic information should be used to determine the impairment. It is

not clear to us why information that is generic in nature would override the asset-specific information.

- The interplay between the individual versus collective impairment models is unclear. When a financial asset evaluated for impairment on an individual basis has no indicators of being individually impaired, the proposed Update requires the financial asset to be evaluated collectively for potential impairment. If the same financial asset subsequently results in some impairment when evaluated individually, it is unclear which assessment and measurement method should be followed subsequently. The example that follows is an illustration of this concern:
 - Entity A purchases Loan 1 at par of \$1,000. Loan 1 meets the requirements to be individually evaluated for credit impairment. Following table shows the initial and subsequent impairment results if Loan 1 is evaluated both individually and collectively³:

	Initial Impairment	Subsequent Impairment
Individually	\$ 0	\$ 8
Collectively	\$ 10	\$ 13

- Based on the proposed guidance, an initial impairment of \$10 should be recorded. However, it is unclear how the subsequent change in the impairment amount should be recognized. Should Entity A continue to recognize impairment based on a collective assessment (i.e., record an additional \$3 impairment for a total impairment charge of \$13) or based on an individual assessment (i.e., reverse \$2 of the previously recognized impairment such that aggregate impairment totaled \$8)?
- In the example above, we note that reversing \$2 of impairment would create a mixed impairment measurement model for Loan 1 and recognizing additional impairment of \$3 would obviate the need for individual impairment assessment for any financial assets with no impairment recorded at inception.

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.

³ The impairment amounts in the “Subsequent Impairment” column are cumulative in nature.

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?

Response: As stated in our responses to Questions 37 and 38, we believe an expected loss approach that would include forecasting future events or economic conditions not in existence at the end of the reporting period would be more appropriate than assuming economic conditions existing at the reporting date would remain unchanged in subsequent periods. Our response to Question 38 also presents suggested revisions to the current incurred loss model that we believe would greatly decrease operational concerns, while still meeting some of the Board's desired objectives for a new credit impairment model.

Either assuming economic conditions existing at the reporting date remain unchanged or forecasting future events or economic conditions would generally be operational. However, the incorporation of probability-weighted possible outcomes into the credit impairment process to estimate credit losses as currently contained in the IASB's model presents operational concerns. For various analytical purposes (i.e., analysis as opposed to accounting recognition), we currently employ a complex econometric model to forecast future credit losses. This model considers forecasted future events or economic conditions; however, this model does not explicitly consider all possible outcomes and assign a probability to each. To enhance our existing model to explicitly include probability-weighted possible outcomes would require changes to our operations and processes that would be extremely complicated, time consuming, and costly, and we do not believe there would be a sufficient incremental benefit over our existing process to justify this cost and effort.

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)?

Response: The usage of historical lost rates in measuring credit impairments will result in a significant change in practice. The current credit impairment guidance for securities does not permit credit impairment evaluation to be conducted on a collective basis. Additionally, credit impairment measurements for securities are generally based on either fair value amounts or estimates of future cash flows, neither of which incorporate historical loss rates in the manner set forth in the proposed Update.

We suggest the Board consider using historical loss rates as an illustration of how to implement the principle articulated in paragraph BC189 of the proposed Update, rather than mandating their use in measuring credit impairments on a collective basis.

For example, we do not use a historical loss rate approach to derive credit impairments across our mortgage loan population. Instead, we use models to derive loss transition rates for aging categories, which provide us an estimate of the incidence of default. We then apply loss severity estimates against the calculated incidences of default in order to arrive at the estimated amount of credit impairments. We believe this approach to be consistent with the principle set forth in paragraph BC189 of the proposed Update, as well as industry practice for mortgage loans.

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?

Response: No, we do not believe that the recognition of interest income should be affected by the recognition or reversal of credit impairments. While we acknowledge the Board's reasoning for proposing the interest income recognition model they did and understand the Board's rationale, implementing such a change presents significant operational complexity and may produce misleading results in an entity's financial statements. Interest income would become misleading because a portion of the credit impairment would be embedded in interest income without an easy way to separate the amount. Furthermore, it may become almost impossible to isolate the true credit impairment as credit impairment is subjectively allocated to various components of comprehensive income, including interest income, provision for credit losses, changes in fair value recognized in net income, and, changes in fair value recognized in other comprehensive income.

The following is a summary of our observations regarding the conceptual merit and other implications of the interest income model in the proposed Update.

Conceptual Merit

Today's incurred loss model has been criticized for permitting higher interest income recognition in early years for assets of poor credit quality and deferring impairment losses into future periods following identification of a triggering event. While we agree that some concern is warranted, the combination of the proposed impairment model with interest income recognition will provide potentially misleading results and may produce unnecessary confusion for users of financial statements.

- Potentially Misleading Results

The lack of a recognition threshold for measuring credit impairments (as introduced in our response to Question 43 above) combined with the “loss over the asset’s life” impairment approach may produce financial results that do not reflect the economic substance of a business and seems to contradict the recommendations made by the SEC’s Advisory Committee on Improvements to Financial Reporting (CIFiR) in its 2008 report⁴. For example, an entity that originates or acquires poorer credit quality assets expects, at a minimum, to receive cash flows in early periods. However, it may expect to experience a principal and/or interest shortfall at some point in the future. Under the proposed Update’s framework, an entity will record immediate credit impairments for any amounts contractually owed that it may not expect to collect (i.e., no recognition threshold) over the life of an asset. As credit impairments affect interest income recognition, a portion of interest that is both owed and, expected to be collected in the current period, will not be reflected as interest income in the current period. Rather, it will be reflected as an increase to the allowance for credit losses.

Linking credit impairments and interest income recognition introduces a new aspect of subjectivity into interest income. Currently, interest income (and net interest margin) is quite comparable across entities and reasonably understood by users of financial statements as it is based on the contractual terms of the financial asset. Additionally, interest income and net interest margin reflect varying levels of risk for the interest-bearing financial assets an entity has invested in or originated (i.e., the higher risk assets yield higher returns than lower risk assets). Introducing the subjectivity, complexity and ambiguity of estimates and assumptions required by an impairment model into the interest income recognition model could result in reduced comparability of net interest margin across entities, and net interest margin that does not reflect the economic risk of the interest-bearing financial assets of an entity. Reducing interest income for estimated principle losses obfuscates the interest related returns on financial assets, and will be inconsistent with the economic decisions made by management.

As an additional matter, recognizing changes in fair value through other comprehensive income is an election under the proposed Update. Entities may choose to record all financial assets at fair value through net income to avoid operational complexities. By doing so, these entities can present measurements of net interest margin that are inconsistent with other market participants by avoiding the prospect of credit impairments affecting their net interest margin (i.e., they will be able to continue to follow current practices relating to interest income recognition).

These examples illustrate that the proposed Update’s interest income recognition model could be counterintuitive to the Board’s objective of simplifying and improving financial reporting.

⁴ *Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission* dated August 1, 2008

- Why “Fix” Something That Is Not Broken?

In our opinion, today’s interest income recognition model, while certainly not perfect, is not “broken” or misleading, despite the level of diversity in practice and ambiguity over non-accrual policies across entities, industries and asset classes. If non-accrual practices were consistently enforced, applied, disclosed and understood, we believe that many of the concerns regarding the current interest income recognition model would be resolved. The recently issued Accounting Standards Update 2010-20, *Disclosures about Credit Quality for Financing Receivables and the Allowance for Credit Losses*, (“ASU 2010-20”) seems to recognize this concern and requires disclosure of information that enables users of financial statements to understand many aspects of entities’ non-accrual practices.

As an alternative to a complete overhaul of the interest income recognition model, the Board could address an area of significant diversity in practice – the accounting for accrued but uncollected interest for loans placed on non-accrual. The Board could accomplish this either by providing more explicit guidance on the application of non-accrual policies to accrued but uncollected interest, or by requiring disclosure of an entity’s policy for accounting for accrued but uncollected interest for loans on non-accrual. If the Board were to provide guidance on how accrued but uncollected interest should be accounted for when a loan is placed on non-accrual (i.e., record a reserve for estimated uncollectible amounts or reverse the accrued amounts against interest income), a significant portion of the diversity in practice would be eliminated.

The proposed Update’s interest income recognition model shifts the judgment from an entity’s non-accrual practices to the assumptions and estimates utilized in that entity’s credit impairment methodologies. While this accomplishes the Board’s objective of only recognizing interest income on the cash flows expected to be received, the manner in which those cash flows are determined is no less complex, challenging or flawed than the current credit impairment model (as discussed in our responses to Questions 37-42 above) and may produce results that are misleading and more diverse in practice.

Other Implications

In addition to our observations on the conceptual merit of the interest income recognition model in the proposed Update, we believe there are also a host of other implications of the proposed interest income recognition model that significantly increase operational complexity. We believe this proposed interest income recognition model would require significant cost and effort to implement, as the majority of our financial systems and sub-ledgers would require significant modification. The following points address these issues:

- Linkage of Contractual Accounting and Credit and Risk Systems

The most prominent operational challenge in implementing the interest income model in the proposed Update will be the linkage of the “contractual accounting” systems (e.g., those that perform amortization and accrue contractual interest) with the credit and risk systems (e.g.,

those that assess and measure impairment). A significant overhaul of our current systems, processes, procedures and controls would need to be planned, designed, implemented, tested and executed as contractual accounting data and risk and credit data are currently housed in a number of separate systems. For example, the contractual accounting systems and processes will need to be modified to enable them to identify and capture the assets within a pool to align with the credit and risk systems that assess and measure credit impairment

- *Assimilation of Different Units of Account*

Another challenge will be addressing the complexities introduced by the assimilation of two different units of account for recognizing interest income. For example, we determine interest income for loans at the individual asset level while impairment may be determined either individually or collectively, depending on facts and circumstances. The proposed Update does not provide explicit guidance on the level of aggregation at which interest income should be recognized.

- *Interest Income Recognized Individually*

If interest income is determined at the individual asset level, the allowance for credit losses that is determined collectively will need to be allocated to the individual asset level. Developing system logic to capture and allocate the allowance to individual assets in a repeatable, controlled, and rationale manner will require considerable time and effort. Diversity in practice in the allocation of the allowance to the loan level will occur, which will diminish comparability across entities.

- *Interest Income Recognized Collectively*

If interest income is determined at the pool level, our contractual accounting systems would need to be modified to be able to continuously recalculate the effective interest rate (EIR) for every pool each accounting period as assets enter or exit the pool on a regular basis.

Contractual interest income is typically determined at the individual asset level as it corresponds with obligor payment cycles. Conversion to a pool level measurement would require our contractual accounting systems to be modified to be able to continuously recalculate the stated interest rate for every pool each accounting period as assets enter or exit the pool. For example, amortization of basis adjustments is typically performed at the individual asset level, as the EIR on a particular asset must remain constant to ensure the integrity of the amortization schedule (i.e., that it will amortize to zero). Nonetheless, conversion to a pool level measurement is not practical as records at the individual asset level will need to be maintained to monitor obligor defaults and other individual asset level information such as determination of non-accrual status.

Accordingly, in either scenario, the proposed Update will necessitate the monitoring and maintenance of contractual data at the individual asset level (e.g., information about basis

adjustments in either scenario) and pool level (e.g., periodic weighted average effective interest rates or information related to impairments determined collectively) for recognizing interest income.

Each of the challenges noted herein associated with the assimilation of two different units of account for purposes of recognizing interest income will likely require creation or modification of processes, procedures and controls to implement the changes and to monitor the complexities mandated by the interest income recognition model in the proposed Update.

- *Quarterly Impairment Assessment versus Monthly Interest Recognition*

Another challenge in implementing the interest income model of the proposed Update will be addressing the complexities due to the timing differences between the accounting for impairments and interest income. Currently, we accrue interest income on a monthly basis to coincide with obligor payment cycles (e.g., most loans and securities pay on a monthly basis). However, we only formally assess and measure credit impairment on a quarterly basis to coincide with our financial and regulatory reporting requirements. It is our understanding that many entities only assess impairments on a quarterly basis and make little to no adjustments during the intervening months. Under the proposed Update, credit impairments and interest income recognition will be linked. As a result, the difference in timing of accounting for impairments and interest income could skew the latter (either favorably or unfavorably) as interest income for the first two months of a quarter could be predominantly based upon the prior quarter's impairment assessment depending on how the difference in timing is interpreted and addressed by each entity. Please refer to our response to Question 51 below for further discussion on the number of ways in which we believe this could be addressed.

One alternative would be to make a true-up adjustment to reflect interest income for the quarter based on the quarter-end assessment of expected cash flows to be received. Performing such adjustments would require development of new sophisticated systems and/or manual intervention, thereby increasing upfront and/or ongoing costs and effort. Alternatively, if formal impairment assessments are expected to be performed monthly to coincide with interest income recognition, the burden associated with the monthly accounting close increases dramatically due to the judgment and subjectivity involved in the impairment assessment and measurement process. Accordingly, the timing differences between accounting for impairments and interest income would create complexities that will result in significant cost and effort to address under the interest income recognition framework in the proposed Update.

- *Non-accrual Practice Changes*

We believe the non-accrual framework of the proposed Update would subject entities to increased operational burden for a financial reporting benefit (conformity in non-accrual application) that can be addressed in a more direct and less costly fashion. It is our understanding that much of the diversity in practice in this area is not necessarily focused on

when the asset is placed on non-accrual status, but *how* to treat accrued but uncollected interest at the point in time the asset is placed on non-accrual. Therefore, we suggest the Board consider proposing targeted guidance on this matter in lieu of the proposed changes.

If the Board ultimately decides to issue the non-accrual framework as currently set forth, we believe the Board should consider providing more detailed implementation guidance than the proposed Update currently includes. The following two observations may help illustrate how the guidance currently found in the proposed Update may need to be clarified to avoid implementation issues:

- Paragraph 82 of the proposed Update provides by way of an example a situation where the gross cash flows of a financial asset, in aggregate, are less than the original principal amount of that asset and notes that the interest income accrual should cease once the yield is determined to be negative. The phrase “original principal amount” may lead to confusion in how this guidance would be applied to financial assets that amortize over their lives such as residential mortgage loans. That is, whether the non-accrual point would consider the current unpaid principal amount or would remain the original principal amount over the life of the asset (thereby increasing the likelihood of the non-accrual trigger being met simply due to normal amortization). We do not believe the Board intended the latter situation to be the case, but believe the current wording of this paragraph could lead to this interpretation.
- Due to the manner in which the proposed Update integrates interest income and credit impairment recognition, it seems hypothetically possible for one to interpret the guidance in paragraph 82 such that no financial asset is ever placed on non-accrual status. This could occur if one were to interpret the “overall yield” language in paragraph 82 to be the accounting yield at which interest income is accrued. As this yield is applied to the financial asset’s amortized cost basis, net of the allowance for credit losses, an entity could reasonably find itself in a position whereby it is comparing undiscounted future cash flows to an amortized cost basis that has been reduced via the allowance for credit losses to a level where the yield calculated on that amortized cost basis would be positive. Further decreases in future cash flow expectations would result in a larger allowance, further depressing the asset’s amortized cost basis, such that the non-accrual trigger would again cease to be met. This pattern could repeat itself, theoretically, until the financial asset was fully reserved. Again, we do not believe this to be the Board’s intended outcome, but merely observe that, absent more specific application guidance, such a conclusion could be reached.

Additionally, if the non-accrual guidance in the proposed Update is ultimately codified by the Board, the complexities involved in performing the required calculations and estimated cash flow projections would require us to modifying systems and processes to implement these changes to current non-accrual practices. To ensure our ability to perform such calculations and projections in a controlled and repeatable fashion will result in additional cost and effort. As an example of one of the complexities we foresee, impairments measured collectively are

to be based upon historical loss rates (and not an expected cash flow analysis), yet the non-accrual determination is to be based upon a cash flow analysis at the individual asset level.

- *Increased Scope of Collective Impairment Assessments*

We believe that the application of the proposed credit impairment model to all financial assets will dramatically increase the number of assets for which impairment is measured collectively. Entities with significant loan portfolios have systems and processes in place for collectively measuring impairment on which they can build and discern best practices. However, even for entities with sophisticated systems in place, the challenge of creating a collective impairment model for all financial assets, including investment securities, would still be significant.

As evidenced by these challenges, we are concerned that the proposed Update's interest income recognition model does not achieve the Board's goal of reducing the complexity in accounting for financial instruments.

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?

Response: We do not agree that the difference should be recognized as an increase to the allowance for credit losses. It is our opinion that interest that is earned and collected should be recorded as interest income in the statement of comprehensive income. While the Board recognizes that net interest margin holds significant value for financial institutions and users of financial statements (an observation we fully agree with), the proposed Update's convergence of an entity's credit impairment process with its interest income recognition methodology will introduce the subjectivity and complexity associated with estimating credit impairments into the interest income recognition framework.

The proposed Update does address the perceived conceptual flaw currently found in U.S. GAAP whereby full interest income recognition occurs on poor credit quality assets in early periods. However, we are concerned that the cost of addressing this conceptual flaw will be the introduction of other shortcomings such as the increased complexity and diversity in practice introduced into the financial statements. These "costs" will lead to less comparability across entities and operational burdens for preparers.

The proposed income recognition model results in interest income being reported at a rate that more closely approximates a risk-free rate than the rate priced into the asset. Assets with lower credit quality that yield higher returns will result in similar amounts of recognized interest income as assets higher credit quality that yield lower returns with the difference being recorded directly to the allowance for credit losses. This outcome may reduce transparency and comparability of net interest income across entities, and will have a smoothing effect on net interest margin (i.e., risk-free rate interest income recognition for all financial assets) and the

provision for credit losses (i.e., risk-inclined entities will have a greater buildup of their allowance for credit losses without any increase to their provision).

We believe that the financial statements should reflect the actual results of business activities, even when the results are volatile. We believe that the income recognition model in the proposed Update will be difficult for users to understand and analyze, particularly when evaluating enterprises with different business strategies (i.e., risk-inclined versus risk-averse). Users will have to evaluate information contained in the footnotes to the financial statements to understand the interplay between net interest income, allowance for credit losses, and the provision for credit losses.

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?

Response: We believe that the interest income recognition framework should be uniform across all financial assets regardless of the measurement attribute. The analysis of interest income and net interest margin are important metrics for financial institutions, so we believe that it is important to have a consistent model with a consistent principle for recognition of interest income for all financial instruments. As introduced in our response to Question 48 above, recognizing changes in fair value through other comprehensive income is an election; therefore entities may well choose to record all financial assets at fair value through net income to avoid the complexities associated with the interest income recognition model set forth in the proposed Update. We do not believe this is a desirable outcome, since the business strategy for most enterprises (particularly financial institutions) is not active trading of all financial assets and liabilities.

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?

Response: No, we do not believe the implementation guidance or illustrative examples are sufficient. We ask the Board to consider expanding on the implementation guidance and illustrative examples included in this proposed Update to ensure that the proposed credit impairment and interest income models are applied consistent with the Board's intention. The operational challenges and complexities introduced by the intersection of the credit impairment and interest income models are significant, therefore detailed implementation guidance and examples would provide ongoing usefulness. For example, a detailed illustration on how to address the timing difference of accounting for impairments quarterly and accounting for interest monthly would be beneficial. There are various ways in which this interplay could be applied as illustrated in the following table:

Background Information					
Facts		Balances			
Amortized Cost	100,000	<u>March 31</u>	<u>April 30</u>	<u>May 31</u>	<u>June 30</u>
EIR	6.00% A	Amortized Cost	100,000	100,000	100,000
Impairment Timing	Quarterly	Allowance	-	-	(25,000)
Impairment at 3/31	-	AC - ALLL	100,000	100,000	100,000
Impairment at 6/30	25,000		B	C	D
				D	E

Potential Ways to Address Difference in Timing of Impairment and Interest Accounting	
Method 1	Use prior month's AC - ALLL for determination of current month's interest income
Method 2	Use current month's AC - ALLL for determination of current month's interest income
Method 3	Use current quarter's average AC - ALLL for determination of current quarter's interest income (thru catch up adjustment)

Results				
	Method 1	Method 2	Method 3	
April Interest Income	A x B	A x C	A x C (tentative)	
AC - ALLL	100,000	100,000	100,000	
Interest Income	6,000	6,000	6,000	G
May Interest Income	A x C	A x D	A x D (tentative)	
AC - ALLL	100,000	100,000	100,000	
Interest Income	6,000	6,000	6,000	H
June Interest Income	A x D	A x E	A x E	
AC - ALLL	100,000	75,000	75,000	
Interest Income	6,000	4,500	4,500	I
June Catch Up Adjustment	<i>Based on Average AC - ALLL for the Quarter</i>			
		Average of B and E	87,500	F
		Quarterly Interest	15,750	A x F x 3
		Monthly Interest From Above	16,500	G + H + I
		Catch Up Adjustment	(750)	
Quarterly Interest Total	18,000	16,500	15,750	

Note: Results do not reflect cash payments, amortization or annualization for simplicity.

As seen through the various interpretations of interaction between the credit impairment and interest income recognition models in the proposed Update presented above, three separate entities could report three different interest income results while following the same basic fact pattern (i.e., the only difference would be the manner in which the guidance in the proposed Update was interpreted). Without explicit guidance or detailed examples to illustrate the application of this interplay, comparability across entities could only be adversely impacted.

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?

Response: Yes, we believe the proposed modification of the effectiveness threshold from highly effective to reasonably effective is appropriate and would simplify the current process that entities are required to apply when considering the effectiveness of a proposed hedging

relationship. Additionally, we believe that providing entities the ability to assess effectiveness through qualitative measures is a reasonable approach that will provide significant benefits from an operational perspective and will eliminate some of the unintended consequences that resulted from the existing requirements of assessing effectiveness quantitatively and requiring the relationship to be highly effective (i.e., failure of a hedge relationship to be highly effective due to the “law of small numbers” when the dollar value offset method of assessing hedge effectiveness was used).

That being said, we believe that additional guidance may be necessary in the proposed Update to clearly articulate the principle to be applied to determine whether a hedging relationship is “reasonably effective”. Paragraph BC220 indicates, “*The Board believes that it is necessary to use judgment when determining whether a hedging relationship is reasonably effective. That judgment should include a holistic consideration of all the facts and circumstances that led an entity to enter into a hedging relationship*”. Our concern is that the principle of a reasonably effective hedge relationship is new and the proposed Update does not provide much interpretive guidance to help ensure that both preparers and auditors will apply it consistently.

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?

Response: We believe continual reassessment after the inception of a hedging relationship should be required; however, we recommend that this reassessment be qualitative, and a quantitative assessment should only be required in circumstances where it is not clear that the hedge relationship was, or is expected to continue to be, reasonably effective using a qualitative assessment. We believe this approach is only logical given that facts and circumstances present at the inception of hedging relationships may change over time. Therefore, reassessment of hedge effectiveness would be appropriate and prudent. Furthermore, we note that a requirement to reassess hedge effectiveness is consistent, at least in part, with the elimination of the shortcut and critical terms match methods of assessing hedge effectiveness.

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?

Response: We believe that a requirement to quantitatively assess the effectiveness of a hedging relationship subsequent to inception only when circumstances suggest the relationship may no longer be effective is a rational approach and will result in a reduction of the number of times a relationship ceases to qualify for hedge accounting.

We believe that the combination of the change in the threshold for assessing hedge effectiveness from highly effective to reasonably effective, along with an ongoing qualitative assessment of hedge effectiveness, will eliminate circumstances where hedging relationships that are highly

effective based on the underlying economics failed to meet the criteria to apply hedge accounting (i.e., when hedge effectiveness was assessed using the dollar value offset approach, and the hedge relationship failed due to the law of small numbers). Developing a monitoring process to qualitatively assess hedge effectiveness on an ongoing basis would be less burdensome than the requirement to complete formal assessments of hedge effectiveness quantitatively as is currently required.

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?

Response: We believe there could be operational concerns or constraints in calculating ineffectiveness for cash flow hedging relationships, but the Board could easily address these concerns.

The Board indicated in paragraph 122 of the proposed Update that the measurement of hedge ineffectiveness shall be based on a comparison of the change in fair value of the actual derivative designated as the hedging instrument and the present value of the cumulative change in expected future cash flows on the hedged transaction (titled the “Change in Fair Value” method). That same paragraph also notes that ineffectiveness may be measured by comparing the change in fair value of the actual derivative to the change in fair value of a derivative that would mature on the date of the forecasted transaction, be priced at current market terms, and provide cash flows that would exactly offset the hedged cash flows (called the “Hypothetical Derivative” method). Both of these prescribed methods of measuring hedge ineffectiveness are appropriate and consistent with current guidance found in Section 35 to Subtopic 815-30 (*Derivatives and Hedging>Cash Flow Hedges>Subsequent Measurement*). As these two methods could result in different amounts of hedge ineffectiveness being recognized, the Board may want to consider clarifying if both methods continue to be acceptable to measure hedge ineffectiveness for cash flow hedging relationships.

If the Board decides to clarify this matter, we believe any significant operational concerns or constraints would be addressed. Overall, we do not believe that simply removing the asymmetry in recognition of hedge ineffectiveness will introduce insurmountable operational challenges. In fact, we believe this will reduce the risk of errors in the recognition of hedge ineffectiveness.

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?

Response: We do not foresee any significant operational concerns or constraints in creating a process 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. We note that hedging relationships are often monitored on an ongoing basis for risk management purposes (i.e., outside of any accounting requirements to do so).

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 de-designating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?

Response: Paragraph 119(b) of the proposed Update states that in order for an entity to prospectively discontinue a hedge accounting relationship, the hedging instrument must be expired, sold, terminated, exercised or an entity can effectively terminate a hedging derivative by entering into offsetting derivative as indicated in paragraph 120. We believe that entities seeking to discontinue a hedging relationship will either settle their existing derivative or enter into an offsetting derivative and may concurrently enter into a new derivative with similar terms to maintain the same economic risk profile. In any of these instances, entities will incur additional fees associated with these activities in order to achieve an accounting result. We believe that this requirement will introduce unnecessary costs without yielding tangible benefits.

The ability to discontinue a hedging relationship is of particular importance to entities that hedge portfolios of assets or liabilities or engage in dynamic hedging strategies. When hedging portfolios, frequent re-balancing of hedge positions is often necessary. By prohibiting an entity from discontinuing a hedging relationship except when derivatives are terminated or paired-off, the cost and the operational burdens associated with hedging portfolios of assets or liabilities will be significantly increased.

Furthermore, the inability to discontinue a hedging relationship as a matter of discretion may result in the reported financial results deviating from an entity's economic risk management measures. Financial reporting will not be improved if entities can no longer reflect the economic reality of hedging on a portfolio basis using dynamic hedging strategies. The rationale for prohibiting discretionary discontinuation of hedging relationships is not clearly explained in the proposed Update. Therefore, we would recommend that the Board consider permitting the discontinuation of hedging relationships on a discretionary basis consistent with the current framework in Topic 815.

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?

Response: We do not foresee any significant operational concerns or constraints arising from the requirement to concurrently document of the effective termination of a hedging derivative attributable to entering into an offsetting derivative instrument. However, as noted in our response to Question 63, if pairing off the derivative is undertaken solely to comply with the requirements of the proposed Update, only to enter into a new position immediately thereafter to

continue an economic hedging relationship, we believe this will present operational challenges, as the documentation burden of the transactions will have increased significantly, introducing the risk of errors and control deficiencies.

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?

Response: No, we do not agree with the proposed disclosure requirements. We believe the proposed Update does not adequately address disclosure requirements for financial instruments measured at FV-OCI. The interplay between the disclosure requirements in paragraphs 99 to 105 of the proposed Update relating to financial instruments measured at FV-OCI and the existing disclosure requirements under existing U.S. GAAP is unclear. For instance, certain disclosure requirements from Topic 320 are carried over into the proposed Update while others are not. As such, it is difficult to determine if the disclosure requirements in the proposed Update replace the disclosure requirements of Topic 320 or Topic 320 should continue to be applicable to investments within the scope of Topic 320 in addition to the proposed Update's disclosure requirements.

For financial instruments measured at FV-OCI, the measurement attribute required by the proposed Update is fair value. However, the disclosures set forth in the proposed Update do not contain requirements to disclose fair value or any changes in fair value (e.g., unrealized gains or unrealized losses at a more granular or disaggregated level). Instead, the proposed Update requires additional disclosures related to amortized cost and allowance for credit losses. If the financial instruments disclosure framework found in existing U.S. GAAP were to be replaced by the disclosure requirements of the proposed Update, footnote disclosures would not agree with the financial statements, which reflect a fair value measurement attribute. Further, the disclosures in the proposed Update do not provide guidance on how these differences should be presented or reconciled.

If existing U.S. GAAP financial instruments disclosure requirements continue to be applicable, it is unclear how these disclosures will be impacted or changed by the proposed Update. For example, existing loan disclosure requirements for loans measured at amortized cost (i.e., loans classified as held-for-investment) contained in Subtopic 310-10 are based on the carrying amount of loans and the allowance for credit losses. The proposed Update does not address disclosures for the new measurement attribute applicable to these loans (e.g., FV-OCI). As a result, it is not clear how these footnote disclosures based on amortized cost and an allowance for credit losses will be reconciled to the statement of financial position which also includes a calculated difference between amortized cost less the allowance for credit losses and fair value, as well as the fair value. Further, the proposed Update does not address whether existing disclosures for loans should be changed to present fair value information, or present both amortized cost and fair value information with equal prominence.

As an additional illustration of the uncertainty around how current financial instrument disclosures will interact with those of the proposed Update. Consider investment securities. Topic 320 requires disclosure of amortized cost, gross unrealized gains recognized in OCI, gross unrealized losses recognized in OCI, and fair value by major investment security type as of each date for which a statement of financial position is presented. The proposed Update does not require calculation of unrealized gains and unrealized losses as currently defined, and gross unrealized gains and losses would no longer be recognized in OCI under the proposed Update. The amount to be recognized in OCI under the proposed Update is a calculated amount that is the difference between amortized cost (net of the allowance for credit losses) and fair value. The disclosures required by Topic 320 do not appear to have been replaced, and the disclosures in the proposed Update do not appear to contemplate the changes in measurement attribute and presentation for investment securities. As a result, it is not clear how to overlay the new presentation and measurement for investment securities measured at FV-OCI with the existing disclosure requirements for the comparable measurement classification, available-for-sale.

Additionally, we strongly disagree with the stated requirement to provide a measurement uncertainty analysis for financial instruments classified as Level 3 in the fair value hierarchy. Please see our response to question 7 of our comment letter on Proposed Accounting Standards Update, *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, dated September 7, 2010.

Lastly, we also question whether the proposed disclosure requirements for hedging activities provide decision-useful information. We would recommend that the Board include objectives based disclosure requirements that would be less prescriptive and leave it to an entity's management discretion to determine a level of detailed information to be provided to make employed hedge strategies transparent to users of financial statements.

We encourage the Board to conduct a thorough evaluation of the disclosure requirements for all financial instruments and compare them with the measurement requirements for financial instruments in the proposed Update to provide comprehensive guidance related to the various classes of instruments. Absent such guidance, we believe there will be significant diversity in practice that will render comparison of financial statements between entities extremely difficult.

Effective Date and Transition

Questions for All Respondents

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

Response: While the transition provisions will make comparison of the financial statements after adoption with those of prior periods extremely complex, we do not believe that we would be able to adopt the proposed Update in any other manner without significant cost and effort. As a result, we agree with the transition provision in the proposed Update.

Questions for Preparers and Auditors

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

Response: The proposed Update would present numerous implementation challenges requiring significant time and resources. Based on a preliminary evaluation of the proposed Update and our current systems and operational capabilities, we estimate that over 50 systems would require modifications and hundreds of models would require significant changes. We estimate that it will take us at least two years and possibly as long as three years to implement the necessary systems and operational processes and controls to allow us to adopt the proposed Update in a controlled fashion. Preliminary cost estimates of adopting the proposed Update range from \$125 million to over \$150 million.

We would like to take this opportunity to note that the SEC in its *Commission Statement in Support of Convergence and Global Accounting Standards* dated March 2, 2010 stated that it expects the first US issuers to begin reporting under IFRS in the 2015-2016 timeframe. Based on their current forms, the financial instrument accounting framework set out in the proposed Update and the corollary framework being developed by the IASB differ markedly from each other. If the proposed Update is codified in its current form with an effective date in 2013 and the adoption of IFRS in the US occurs along the timeline the SEC envisions, we are concerned that entities would be required to adopt the framework set forth in the proposed Update (at significant cost and effort) only to then transition over to another accounting model for financial instruments. Two significant transitions within a short time period are both inefficient and costly.

Therefore, we would encourage the Board to use this opportunity to make all attempts to resolve the current differences between the U.S. GAAP and IFRS accounting models for financial instruments. This will eliminate what would be two costly and comprehensive implementations within a short period of time.

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

Response: As noted in our response to Question 68, we believe the transition provisions will complicate the comparison of the financial statements after adoption with the prior period; however, we believe that proposed transition provisions are operational.

Additional Observation

We have added the additional observation below to address what we believe is a significant matter arising from our read and review of the proposed Update where the Board did not ask any specific questions. This matter was addressed outside of our responses to the questions in the proposed Update so as not to impair the readability of those responses.

Paragraph 83 of the proposed Update states that a recovery on a financial asset previously written off shall be recognized (only) when cash is received. In addition to the receipt of cash, we believe there are other instances where a recovery could be reasonably recognized. For instance, the mortgage market utilizes various forms of credit enhancements and these credit enhancement arrangements allow holders to make claims for collection when certain pre-defined events occur. We are of the view that recovery should also be recognized when collectability is reasonably assured on claims made under these credit enhancement arrangements.

The most prominent form of the aforementioned credit enhancements is Primary Mortgage Insurance (“PMI”). We require PMI when the loan amount exceeds 80% of the value of the property that collateralizes the loan.

Based on the current form of paragraph 83 of the proposed Update, we believe there are several different ways to interpret this language, which may be inconsistent with established practice, and may present financial results that are inconsistent with the economics of the transaction. For example, one possible interpretation of the guidance in paragraph 83 of the proposed Update is that when a loan is charged off, if a PMI claim is filed but the cash payment has not yet been received, the amount charged off will be presented gross, without consideration for the receivable from the PMI provider. The proceeds from the PMI claim would only be recognized on receipt of the cash.

The following example illustrates how paragraph 83 of the proposed Update could be applied under such an interpretation:

Facts:

- Entity A holds a mortgage loan (Loan X) and Entity A’s year end is December 31
- Loan X’s borrower is not able to make the required contractual payments and Loan X ultimately is foreclosed upon on 1/1/2010
- Assume the following for Loan X
 - Carrying amount (i.e., remaining unpaid principal)⁵ = \$100,000
 - Allowance for loan losses = \$0⁶
 - Value of the underlying collateral = \$90,000
 - PMI coverage = \$10,000
- On 4/15/2010, PMI provider pays \$10,000 cash for the claim that was filed on 1/1/2010. Based on historical data and current circumstances, collection from the PMI provider is reasonably assured.

⁵ For simplicity, assume Loan X was purchased at par with no other basis adjustments.

⁶ Assume allowance is individually calculated using PV of expected future cash flows. Allowance for loan losses is zero as the entity determined that all \$100,000 is collectable (\$90,000 from the underlying property and \$10,000 from PMI claims).

1/1/2010 – Entity A’s journal entry at the time of foreclosure (i.e., write-off event)

Dr. Real estate owned	90,000	
Dr. Provision for Credit Losses	10,000	
Cr. Loan		100,000

To recognize the fair value of the real property upon foreclosure of Loan X and the resulting charge-off (Provision for Credit Losses in this case, since there was no Allowance for Credit Losses recognized)

4/15/2010 – Entity A’s journal entry at the time of cash payment from PMI company

Dr. Cash	10,000	
Cr. Provision for Credit Losses ⁷		10,000

To recognize a recovery for the receipt of cash from the PMI claim

Using this interpretation of paragraph 83 of the proposed Update, a provision for credit losses is recognized during the first quarter of 2010, because cash had not yet been received from the PMI claim, even though the claim may have been filed during the quarter and collection was reasonably assured. We believe that this guidance is in conflict with existing U.S. GAAP for the accounting for the receipt of collateral, as described in Topic 860-30-25 (*Transfers and Servicing, Recognition*), where collateral should be recognized at fair value on default by the borrower.

⁷ Paragraph 83 of the proposed Update does not specify how to record recoveries; however, recoveries are typically recognized within the allowance for credit losses. Given the Allowance for Credit Losses for this loan is \$0, a reversal of the Provision for Credit Losses is recognized in earnings.