June 17, 2011

Susan M. Cosper  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: Financial Instruments Classification and Measurement

Dear Ms. Cosper:

The Bank of New York Mellon Corporation (“BNY Mellon”) wishes to comment on the Summary of Redeliberations as of May 5, 2011, related to Financial Instruments Classification and Measurement. BNY Mellon is a global financial institution with $247 billion in assets, including $66 billion of investment securities, $68 billion in deposits placed at banks and $37 billion in loans. Accordingly, we are very familiar with the business strategies applied to financial instruments.

We agree with the overall “business strategy” principle the FASB has tentatively adopted, that is:

The Board decided that an entity should classify financial instruments that meet the characteristics of the financial instrument criterion based on the business activity the entity uses to manage those financial instruments rather than on the entity’s intent for an individual financial instrument. An entity would be permitted to manage identical or similar instruments through different business activities. An entity would be required to classify all financial instruments into one of three classification and measurement categories.

However, we believe that narrowly defining the business activities that qualify for the amortized cost category is overly prescriptive, conflicts with the stated principle that “an entity would be permitted to manage identical or similar instruments through different business activities” and does not recognize the variations in the strategies employed in managing financial instruments.
The second business activity condition for the amortized cost category limits this category to:

Financial instruments for which the holder of the instrument has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss.

Effectively, the only assets that meet this condition are loans; and investment securities would be precluded from this category. None of the other categories have such product based conditions and there is no reasonable business strategy reason for doing so. In response to the Board’s first Exposure Draft, many constituents opposed the imposition of fair value accounting when that measurement did not reflect the way in which financial instruments are managed. Artificially imposing a constraint that does not reflect the fact many bonds have interest and principal repayment such that creditors can hold them for the collection of those cash flows appears to be imposing fair value accounting in the same area in which there was previously so much objection.

This “product” specific condition severely limits the prudent management of financial institution resources. This seems to be a direct contradiction to the business strategy principle. In planning long term investment decisions that balance returns, credit risk, liquidity risk, cost of capital and volatility, we believe companies should have the ability to include financial instruments where the activities are focused on the collection of substantially all of the contractual cash flows from the borrower/issuer in the amortized cost category - including government bonds, municipal bonds and corporate bonds.

The Board’s conditions for the categorization of financial instruments (e.g. loans and bonds) seem to focus only on credit risk and liquidity risk management. This is overly simplistic in that businesses consider many other activities that are important to the management of financial instruments (e.g. market risk management, capital management, collateral management) in developing the appropriate strategy for a particular instrument. In addition, credit risk management is much more involved than being able to renegotiate loan terms with the counterparty and is a consideration in acquiring other financial instruments, including government and corporate bonds. By being overly prescriptive, the available business strategies for long term bonds are severely limited.

For example, in 2011 our firm has to plan and anticipate how the investments we make will be affected by the long term risk/return trade-off for financial instruments where the activities are focused on the collection of substantially all of the contractual cash flows. As we emerge from the recent financial crisis, certain business strategies are focusing on substantial risk reduction. Credit risk management and liquidity risk management are significant considerations in the acquisition of both bonds and loans for the long term. However, bonds would add significant volatility and risk to capital compared to loans simply because of the proposed accounting rule. Logically, this doesn’t make sense when we expect the opportunity to acquire bonds with high credit quality and liquidity may be greater than the opportunity to acquire loans of similar characteristics.
Below shows the changes we recommend to the conditions for the amortized cost category classification:

Amortized Cost Category

The business activity for these financial instruments must meet all of the following conditions:

1. Financial instruments issued or acquired for which an entity’s business strategy, at origination or acquisition of the instrument, is to manage the instruments through customer financing (lending or borrowing) activities. These activities primarily focus on the collection of substantially all of the contractual cash flows from the borrower or payment of contractual cash flows to the lender.

2. Financial instruments for which the holder of the instrument has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. Sales or settlements would be limited to circumstances that would minimize losses due to deteriorating credit. [Add the other circumstances included in current ASC 320-10-25-6].

3. Financial instruments that are not held for sale (assets) or transfer (liabilities) at acquisition or issuance.

We believe these changes would be make the conditions more consistent with Board’s principles and allows the entities who are most knowledgeable about their strategies for financial instrument to apply the principles.

Furthermore, we believe that the judgment involved in determining whether or not a creditor “has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss” will be overly complex without any improvement in the accounting results. When bonds are at risk of default generally a creditor committee is formed to negotiate terms; will only those creditors that are (or are expected to be) on the committee be considered to meet this criterion? Or will all creditors be included because the committee’s power emanates from all creditors? Likewise, for loans that are syndicated or participated, which creditors are considered to meet this criterion? Since debtors in the US generally have the legal right to obtain court protection from their creditors which negates the creditors’ ability to negotiate with a debtor, would any US loans meet this criterion? In addition, traditionally placements of funds at other financial institutions, including central banks, have been recorded on an amortized cost basis. While we believe they should continue to qualify for such treatment, it is not clear how this criterion would be applied to such instruments.

Finally, the Board’s criteria are not consistent with the IASB’s principles incorporated into IFRS 9, Financial Instruments, in paragraphs 4.1.2 and 4.1.3 for which the IASAB provided further guidance in paragraphs B4.1.1 through B4.1.26. IFRS 9 §4.1.2 and §4.1.3 state:

4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:

a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flow
b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the on the principal amounts outstanding.

Those principles and the IASB’s guidance in paragraphs B4.1.1 through B4.1.26 do not exclude bonds from the amortised cost category. In fact, the IASB explicitly states that bonds may be included in amortised cost in §B4.1.10 and in the examples provided in §B4.1.13. Accordingly, while we understand the FASB and IASB continue to discuss whether there should be an additional FV-OCI category, we believe the unnecessary credit criteria the FASB is proposing is inconsistent with the IASB’s principle that a financial asset shall be measured at amortised cost if the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows which are solely payments of principal and interest on the principal amounts outstanding.

Thank you for considering our comments. If you have any questions or require further information, please contact me at 212-635-7080 or Robert Hitchings at 212-635-7083.

Sincerely,

/s/ John A. Park

John A. Park
Controller

cc: Leslie F. Seidman, Chairman, FASB
    Sir David Tweedie, Chairman, IASB
    Hans Hoogervorst, Chairman-elect, IASB
    Alan Texeria, Technical Director, IASB
    Roger Kaiser, Senior Advisor, European Banking Federation Accounts Committee
    Arthur W. Lindo, Senior Associate Director, Federal Reserve Bank
    Sylvie Matherat, Chairman, Basel Committee Accounting Task Force
    Gerald A. Edwards, Jr., Senior Advisor on Accounting and Audit Policy, Financial Stability Board