May 15, 2013

Technical Director
File Reference No. 2013-220
FASB
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Via email: director@fasb.org


Dear Technical Director:

State Street Corporation (State Street) appreciates the opportunity to comment on the Financial Accounting Standards Board’s Proposed Accounting Standards Update, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (Proposed ASU). State Street is a leader in providing financial services and products to meet the needs of institutional investors worldwide, with $25.4 trillion of assets under custody and administration and $2.2 trillion of assets under management as of March 31, 2013.

We acknowledge and support the efforts of the Financial Accounting Standards Board (FASB, or the Board) to establish an improved and more consistent financial reporting model for the recognition, measurement and presentation of financial instruments, while attempting to reduce the complexity in accounting for those instruments. Currently, there are many different accounting models for financial instruments, and the proposal represents a step in the right direction. In order to provide investors with decision-useful information, and enable companies to better articulate how investment portfolios are managed, we agree with the Board that the accounting model for financial instruments should reflect how the entity manages its business. The Proposed ASU attempts to link the measurement of a financial asset to the manner in which an entity expects to benefit from the related cash flows. Accordingly, we support a mixed-attribute accounting model for financial instruments with the three proposed categories (fair value through net income, fair value through other comprehensive income, and amortized cost).

However, we do not support the Proposed ASU in its current form, as we do not believe the proposal provides a meaningful improvement over the current accounting framework for financial instruments. As we discuss in this letter, we believe a company’s business model should be the priority in determining classification and measurement attributes, while cash flow characteristics should, at most, be of secondary importance. Also, we believe the Proposed ASU does not simplify the accounting, but rather introduces
additional operational complexity and may result in financial reporting misaligned with an entity’s business model. Certain constraints in the proposal limit an entity’s ability to appropriately report how financial assets are managed by the entity. Said differently, while the Proposed ASU incorporates the business model concept in determining the appropriate classification and measurement of financial instruments, when combined with the Proposed ASU’s additional cash flow characteristics provisions, the result may not be consistent with an entity’s actual business model or how an entity intends to benefit from a financial asset’s cash flows. Furthermore, the Proposed ASU would cause additional assets to be classified at fair value through net income, and the resulting volatility would distort earnings by making it less representative of a company’s operations—especially when fair value measurements may be less reliable due to limited market depth or liquidity.

Therefore, we offer comments herein that we believe propose actions necessary to achieve the proper balance between improving comparability across entities, while providing financial statement users relevant and reliable information to evaluate an entity’s financial performance.

**Contractual Cash Flow Characteristics**

Under the Proposed ASU, a financial asset would qualify for classification and measurement at amortized cost or fair value through other comprehensive income only if its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding. We recognize the Board’s intent in permitting only simple debt instruments to be classified and measured at other than fair value through net income. While the evaluation of and accounting for embedded derivatives under current accounting rules may be challenging to understand and apply in practice, we are concerned that the replacement of the embedded derivative guidance with guidance on “solely principal and interest” may not simplify and improve the accounting in this area, as we note below. Instead, we support a more adaptable application of the SPPI test subject to appropriate operating and governance controls, or preferably, an elimination of the test altogether (and retention of the existing “clearly and closely related” embedded derivative bifurcation criteria for financial assets) with a focus solely on business model.

As currently proposed, the definition of “principal” as the amount transferred by the holder at initial recognition is too narrow and may lead to financial assets being classified in certain categories inconsistent with a company’s business model. This definition has broad implications since, for example, financial assets are routinely acquired in secondary markets at a premium or discount reflective of current market rates. Simply because a plain vanilla prepayable financial instrument is acquired at a premium or discount should not force that instrument to be classified at fair value through net income, when that instrument is held in a business model to hold to collect contractual cash flows. We suggest the Board consider broadening the definition of “principal” to include the par or face amount of debt, as that amount is more representative of the contractual cash flows of the financial asset, and therefore more in line with the concept of “collection of principal cash flows.”

For prepayable financial assets or beneficial interests in securitized financial assets, the SPPI criteria will be challenging to apply in practice, as it will be difficult for entities to assess whether the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount
outstanding. In particular, the detailed look-through instrument-by-instrument analysis for beneficial interests is especially burdensome, as companies with large portfolios may be challenged to obtain the information needed to evaluate the underlying pool of assets in certain securitizations. To address this concern, and to simplify the accounting, we suggest the Board replace the SPPI rules with a more flexible principles-based approach focused on how an asset is managed together with other assets within a distinct business model.

Furthermore, in evaluating the impact of contingent cash flows, the Proposed ASU stipulates that the probability of the contingent cash flows occurring would not be considered, except for disregarding events that are extremely rare, highly abnormal, and very unlikely to occur. We are concerned that this may lead to certain financial assets being classified into fair value through net income in situations where the business model is to hold that instrument for collection of contractual cash flows. For example, certain subordinated debt issued by financial institutions may contain contingent conversion or suspension features which would only be triggered in situations where the issuer experiences financial difficulties. These contingent features may force the debt to be classified in fair value through net income by investors, even though it is held in a business model to hold for collection of contractual cash flows. If the Board decides to retain the cash flow characteristics test, rather than requiring the consideration of remote contingencies, we support an accounting framework that is more in line with considering probable or expected outcomes, while considering the significance of the feature in altering a financial instrument’s cash flows. A remote feature or a likely feature that would not have a significant impact on a financial instrument’s cash flows should not preclude classification in amortized cost or fair value though other comprehensive income. This would align with the intended objective of the Proposed ASU in matching the reporting of financial assets with a company’s business model, and avoid an accounting model impacted by remote scenarios unlikely to occur or attributable to insignificant features. We believe that an accounting framework based on a most likely outcome would be more meaningful for financial statement users.

**Business Model for Managing Financial Assets**

As we noted earlier, we agree with the Board that the accounting model for financial instruments should reflect how the entity manages its business. Accordingly, we support a mixed-attribute accounting model for financial instruments with the three proposed categories (fair value through net income, fair value through other comprehensive income, and amortized cost). However, we are concerned that the prohibition on reclassifications is too restrictive, as it does not acknowledge the nature with which companies manage their business operations or credit risk exposures, and therefore may cause companies to classify financial instruments in the fair value through other comprehensive income category when the true business model is to hold those instruments for the collection of cash flows.

Under the Proposed ASU, an entity would not be permitted to reclassify financial assets between measurement (or business model) categories, except under very limited or infrequent situations. Financial institutions in particular have a dynamic asset-liability management process, and changes in a company’s liquidity risk or interest rate risk profile may necessitate occasional portfolio rebalancing which may be restricted under the Proposed ASU. While we acknowledge that the fair value through other
comprehensive income category would allow for the flexibility to perform portfolio rebalancing, the desire for this flexibility alone should not motivate a company to classify its entire investment portfolio into this category when a company’s primary intent is to hold the securities for collection of cash flows. Doing so would distort the reporting of a company’s business model in instances where sales would be rare.

Accordingly, we believe financial instrument classification provisions based on business model should consider that a company does not operate in a static environment and may need to make portfolio rebalancing decisions from time to time. In particular, a company may want to minimize credit risk to a particular issuer or address concentration risk in a particular industry or sector in response to economic conditions on an infrequent basis without altering the entire reporting framework for the investment portfolio. For example, based on a detailed predictive credit assessment, a company may want to sell a security classified at amortized cost in advance of its actual evidenced credit deterioration (e.g., credit rating downgrade) in order to protect shareholder value—but doing so could call into question the company’s ability to classify other financial instruments at amortized cost. Also, a company may seek to reduce its concentration risk to a particular industry or sector, another condition which is not one of the permissible reclassification scenarios. Restrictive reclassification criteria hinder a company’s risk management process and does not result in an improvement over the current accounting framework for similarly classified instruments, since management would need to consider the implications of accounting restrictions when making sound business decisions. If the Board is concerned with management abuse, this can be addressed through disclosure of the impact of the reclassification, and the business rationale for performing the reclassification. In order for companies to maintain the flexibility to sell, we do not believe the solution is to fair value all financial instruments to reflect potential but unlikely sale scenarios, especially when fair value measurements may be less reliable due to unobservable inputs.

Presentation and Disclosure

We support the proposed change in the presentation of foreign currency transaction gains or losses on foreign-currency-denominated financial instruments measured at fair value through other comprehensive income. This will better align the accounting with the economics related to the currency of an entity’s funding and related investments. Additionally, this will eliminate the need for specific information systems configurations to carve out the treatment of foreign currency transaction gains/losses for only those financial assets classified as fair value through other comprehensive income.

However, we do not support the significant changes to the current financial statement presentation requirements for financial instruments in the statement of financial position or statement of comprehensive income. The proposed changes will complicate the financial statements by adding unnecessary complexity or duplicating information that is already presented in the footnotes. For example, we do not believe the parenthetical presentation of fair value or amortized cost on the face of the balance sheet provides a meaningful improvement, since this information is already presented in investment or fair value footnotes, together with a narrative of how those fair values were determined. We believe this narrative is critical in understanding the fair value information as it provides the necessary context. Financial statement footnotes are an integral part of the financial statements, and if the Board
Technical Director  
Financial Accounting Standards Board  
May 15, 2013

wants to provide valuable information to financial statement users, we encourage the Board to strike the right balance between expanding the financial statements and enhancing footnote disclosures so that users do not get lost in an overly complicated financial statement.

Effective Date

The Proposed ASU will be burdensome operationally to implement, as several aspects of the proposal would require management to develop new processes that previously would not have been subjected to audit or financial reporting controls. In particular, the cash flow characteristics test will require a detailed security-by-security analysis—and this test will be particularly onerous for beneficial interests in securitized financial assets, since companies will need to evaluate the underlying pools of each individual structure to determine whether all of the conditions in the Proposed ASU are met. Also, in certain cases where financial instruments are required to be classified in fair value through net income because they fail the SPPI test, yet are held in a hold-to-collect business model, the accounting will not align with a particular business model, thus requiring a company to develop a new financial reporting process separate from the business reporting used internally by management, with a reconciliation between the internal and external views. If the Board decides to proceed with the Proposed ASU, and the related proposal on credit losses, we would request the Board to consider an adoption period of at least three (3) years for those two proposals. This extended adoption period would provide financial institutions with sufficient time to develop new processes and systems, as well as implement and test appropriate controls.

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We appreciate your consideration of our comments and welcome the opportunity to discuss them with you.

Sincerely,

Sean P. Newth
Senior Vice President and Director of Global Accounting Policy