

KPMG LLP 757 Third Avenue New York, NY 10017 Telephone 212 909 5600 Fax 212 909 5699 Internet www.us.kpmg.com

September 2, 2010

Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut 06856-5116

RE: Proposed Accounting Standards Update, "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities" (File Reference No. 1810-100)

Dear Technical Director:

We appreciate the opportunity to comment on the proposed Accounting Standards Update, "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities" (the "proposed ASU" or "the proposal"). This response to the FASB's proposed ASU has been prepared by the US member firm of the KPMG network. We also have consulted with the global network of KPMG's member firms, which support the views expressed herein.

We acknowledge and support the FASB's efforts to reduce complexity and respond to calls to provide investors with more useful, transparent, and relevant information about an entity's financial assets and financial liabilities. However, for the reasons summarized below, we do not support the finalization of the proposal as currently drafted.

We believe that convergence between United States generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs) is an important objective. High-quality, globally-accepted accounting standards related to the accounting for financial instruments and hedging activities that can be consistently applied can lead to increased comparability of financial information among entities and the usefulness of the information available to financial statement users in making decisions related to the allocation of capital. While the FASB's proposal encompasses the classification, measurement, and impairment of financial instruments, as well as the accounting for hedging activities, the IASB has issued a final standard on the classification and measurement of financial assets and exposure documents on impairment and classification and measurement of financial liabilities but has not yet issued its proposal on hedging.¹

¹ International Financial Reporting Standard No. 9, Financial Instruments; IASB Exposure Draft, Financial Instruments: Amortized Cost and Impairment (ED/2009/12); and IASB Exposure Draft, Fair Value Option for Financial Liabilities (ED/2010/4).



The FASB's proposal and IASB's guidance contain fundamental differences, such as when financial assets would be measured at fair value with changes in fair value recorded in net income or in other comprehensive income (OCI) or at amortized cost, when financial liabilities would be measured at amortized cost, fair value, or a mixture of the two, and how financial assets would be evaluated for impairment. We believe that the FASB and IASB will miss a significant opportunity to demonstrate their commitment to convergence if there is divergence on such a fundamental aspect of financial reporting as the accounting for financial instruments and hedging activities. In addition to the difficulties in understanding and comparability that divergence causes for financial statement users, members of the FASB/IASB Expert Advisory Panel (EAP) have noted that implementation of different FASB and IASB impairment proposals simultaneously by entities that have operations that apply GAAP and IFRSs would be a significant operational challenge. We believe that it is important for the FASB and IASB to work together in order to achieve high-quality, converged solutions.

Overall

Separate from the issue of convergence, we do not support the issuance of the proposal as currently drafted based on certain conceptual differences we have related to the classification and measurement of financial assets and financial liabilities, and the impairment of financial assets. Although we agree that the fair value of financial instruments provides important information to financial statement users that should be presented in the financial statements, we do not agree that fair value is the appropriate measurement attribute for practically all financial assets and the majority of financial liabilities. We also do not observe a clear consensus for such measurement attribute changes from users of financial statements. Therefore, we support the development of a mixed-attribute classification and measurement model more similar to that required and proposed under IFRS guidance. In addition, we do not support the proposal's requirement to immediately recognize all expected credit losses or to consider only past events and existing conditions when evaluating credit impairment. Instead, we support the development of an alternative impairment model that would utilize aspects of both the FASB's proposed model and the model proposed in the IASB's ED/2009/12.

The following describes in more detail the characteristics of the alternative classification and measurement and impairment models that we would support, and our preliminary views on the proposed changes to hedge accounting.

Classification and Measurement of Financial Instruments

The main reason we do not support the proposed classification and measurement model is that we believe the measurement of certain financial assets and financial liabilities at



amortized cost provides more decision-useful information to financial statement users than fair value as further discussed below. However, we believe that information about fair value of financial instruments is relevant to financial statement users. Accordingly, rather than removing the disclosures related to fair value of financial instruments in current GAAP as the FASB proposes since such information would be reflected on the statement of financial position, we believe those disclosure requirements should be preserved and their prominence enhanced.² For example, one option could be to require parenthetical disclosure of fair value on the statement of financial position.³

Certain FASB members support the proposed classification and measurement model because it would result in fair value information about financial instruments being available earlier (i.e., included in an entity's earnings release), rather than only being disclosed when the entity issues its interim or annual financial statements. We do not believe that this is an appropriate premise for changing the measurement attribute of a significant number of financial instruments. In addition, the FASB does not have the authority to prescribe the type of information that should be contained in press releases and should not create accounting requirements as a reaction to a perceived flaw in those releases.⁴

Financial assets and financial liabilities would be evaluated differently under our alternative classification and measurement model. In general, financial liabilities would be measured at amortized cost, while financial assets would be measured at amortized cost only if certain criteria related to the instrument's cash flow characteristics and the entity's business model are met. This differentiation results primarily from concerns raised by financial statement users. While financial statement users often communicate the need for information related to the fair value of financial assets, they do not appear to place the same importance on the fair value information related to financial liabilities, unless the financial liability is being traded or is a derivative instrument. That is in part due to significant concerns regarding the usefulness of information that reflects changes in fair value on an entity's liabilities arising from changes in the entity's own credit standing.⁵

One benefit of our alternative model is that the Boards would potentially be able to reach convergence by means of a more streamlined process because this model is similar in many respects to IFRS 9 and the IASB's ED/2010/4.

² FASB ASC Topic 825, Financial Instruments

³ Question 13. Throughout this letter and related Appendix, we have identified the Questions for Respondents from the proposal addressed by our comment.

⁴ Question 24

⁵ Questions 13 and 15



The following describes in more detail the characteristics of our alternative classification and measurement model.

Financial Assets

All financial assets would be measured at fair value with changes in fair value recognized in net income (FVTNI), unless certain criteria related to the instrument's cash flow characteristics and the entity's business model are met. These criteria are based on the premise that amortized cost provides the most decision-useful information to financial statement users related to financial assets that an entity plans to hold to collect contractual cash flows consisting of payments of principal and interest on specified dates. Therefore, similar to IFRS 9, our alternative model would require that financial assets be measured at amortized cost if:

- The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows, and
- The contractual terms of the financial asset give rise on specified dates to cash flows that are payments of principal and interest on the principal amount outstanding.⁶

We believe that the criteria in IFRS 9 are generally a better starting point for determining which financial assets would be required to be measured at amortized cost because they are more principles-based than the fair value through OCI criteria contained in the FASB's proposal. In addition, our alternative model would be less complex than the FASB's proposal because it would not require a bifurcation analysis of embedded derivatives within hybrid financial assets.

We acknowledge that some application issues related to the amortized cost criteria in IFRS 9 have arisen, in particular the requirement that cash flows represent "solely" payments of principal and interest and the related guidance on nonrecourse financial assets and assets with variable interest payments. These issues indicate that further clarification may be beneficial to allow entities to apply judgment to determine whether the contractual cash flows of a financial asset in substance represent payments of principal and interest and to promote consistent application.

Financial assets that are prepayable, puttable, contain term extensions or that are contractually linked would be evaluated similarly to those instruments under IFRS 9.

⁶ Question 13



Similar to IFRS 9, our alternative model would provide entities with an election to present subsequent changes in the fair value of an investment in an equity instrument not held for trading in OCI, rather than net income. The amounts presented in OCI would not be recycled to net income, thus not requiring an impairment model for these instruments; however, dividend income would be recognized in net income. This approach would measure these instruments at fair value, but not reflect gains or losses in net income since they are not being held primarily for increases in their fair value.

Entities would not be allowed to elect to measure a financial asset that meets the amortized cost criteria at fair value. FVTNI would be the default measurement category and financial assets that an entity wants to measure at fair value likely would not meet the business model criterion.

Hybrid financial assets would be classified based on the evaluation of the hybrid financial asset in its entirety following our alternative model discussed above. This decision is based on (1) the fact that current GAAP related to embedded derivatives is complex and difficult to apply, especially the evaluation of whether an embedded derivative is clearly and closely related to the host contract, and (2) our view that fair value provides the most decision-useful information for financial assets that do not meet the specified amortized cost criteria. Therefore, entities should only be required to evaluate embedded derivatives if the benefit to financial statement users of measuring embedded derivatives at fair value and host financial asset contracts at amortized cost outweighs the costs of performing the evaluation. In the case of financial assets, we believe the cost of evaluating embedded derivatives outweighs the usefulness of providing information about embedded derivatives at fair value and host financial asset contracts at amortized cost. Therefore, the evaluation of hybrid financial assets in their entirety would significantly simplify the accounting for these instruments without eliminating important information for financial statement users.

In addition, we believe that a hybrid financial asset that contains an embedded derivative feature with a de minimus fair value could meet the amortized cost cash flow criterion and therefore, the entire hybrid instrument would be measured at amortized cost. However, in a circumstance where the embedded derivative feature would cause the hybrid financial asset to not meet the amortized cost cash flow criterion, we believe that the embedded derivative has a significant enough impact that the hybrid instrument would be measured at FVTNI as that measurement attribute would provide more useful information to financial statement users than amortized cost.⁷

⁷ Question 25



Our alternative model would not incorporate the FASB's proposed changes to the criteria for use of the equity method of accounting. We do not understand the FASB's conceptual basis for these changes and we are not aware of any current practice issues that would call for such changes. Therefore, an investor generally would apply the equity method of accounting to an investment in equity securities when the investor has significant influence over the investee as described in FASB ASC Topic 323.⁸

Financial Liabilities

As previously stated, due to the fact that financial statement users generally place less importance on the fair value of financial liabilities than financial assets, in part due to concerns regarding the usefulness of information that reflects the changes in fair value arising from changes in the entity's own credit standing, we believe that the most relevant measurement attribute for the majority of financial liabilities is amortized cost. Therefore, all financial liabilities would be measured at amortized cost, except for derivative instruments and financial liabilities held for trading, which would be measured at FVTNI.¹⁰

Entities would be permitted to elect to measure any financial liability upon initial recognition at fair value with all changes in fair value recognized in net income (except for changes in fair value related to changes in the entity's own credit standing, which is further discussed below). Our alternative model would not require that any qualifying conditions (i.e., measurement attribute mismatch) be met in order to elect the fair value option. The election would be available on an instrument-by-instrument basis and would be irrevocable.

In a circumstance where an entity elects to measure its own financial liability at fair value, changes in the fair value of the financial liability related to the entity's own credit standing would be recorded in OCI and recycled into net income if the financial liability is settled such that a gain or loss is realized. This amount would represent the total changes in fair value attributable to changes in the entity's own credit standing including the change of the price of credit (which would be excluded from the calculation in the FASB's proposal). We believe that this approach would address the concerns raised regarding the usefulness of information that reflects changes in the fair value in an entity's liabilities arising from changes in the entity's own credit standing without adding a complex calculation to separate those changes into components. The alternative model would not require a specific methodology for calculating the amount of the change in the fair value of the financial liability related to changes in the entity's own credit standing;

¹⁰ Questions 13 and 18

⁸ FASB ASC Topic 323, Investments—Equity Method and Joint Ventures

⁹ Ouestion 4



however, entities would be required to disclose the method used to calculate this amount. 11

Hybrid financial liabilities would be evaluated similarly to hybrid instruments under current guidance. Although the current GAAP guidance on embedded derivatives is complex and difficult to apply, our proposal is based on the view that important information about an embedded derivative feature may be obscured if an entity evaluated the classification of the hybrid financial liability in its entirety under the basic premise of our alternative model that amortized cost is the most relevant measurement attribute for financial liabilities. Therefore, in contrast to our views on hybrid financial assets, we believe that the benefit to financial statement users of providing information about embedded derivative features at fair value and host financial liability contracts at amortized cost outweighs the costs required to complete the evaluation and potentially separate an embedded derivative from the hybrid financial liability.

As such, entities would be required to analyze hybrid financial liabilities to determine if separation of an embedded derivative is required. If separation is required, the host contract would be accounted for at amortized cost and the embedded derivative would be accounted for at fair value with changes in fair value recognized in net income. If no separation is required, the entire hybrid instrument would be accounted for at amortized cost.

Specialized Measurement

Our alternative model would not provide specialized measurement guidance for coredeposit liabilities, loan commitments and stand-by letters of credit, short-term receivables or payables, investment companies, and brokers/dealers in securities. The specialized guidance related to core-deposit liabilities (which is intended to provide an economic offset to the change in the fair value of loan portfolios under the FASB's proposal) would not be necessary under our alternative model because many loans would be measured at amortized cost, rather than fair value.¹²

Similar to the FASB's proposed model, our alternative model would require investments that are not held for capital appreciation and can be redeemed with the issuer only for a specified amount to be measured at their redemption value and evaluated for impairment.

Reclassifications

Similar to IFRS 9, existing financial assets would be required to be reclassified when an entity changes its business model for managing those financial instruments (although it is

.

¹¹ Ouestion 32

¹² Questions 17 and 31



expected that an entity's business model would rarely change). Although reclassifications may be considered to reduce comparability and add complexity, we believe financial assets should be measured based on an entity's current business model. This would provide the appropriate information to financial statement users (i.e., amortized cost or fair value).¹³

Credit Impairment and Interest Income Recognition

We support the FASB's proposal to establish a single impairment model that would be applied to all financial assets, and believe the use of a single impairment model will reduce complexity and provide financial statement users with more understandable and comparable information. However, we do not support the FASB's proposed impairment model in its entirety.

While we agree with the proposal's objective to reduce delays in recognizing credit impairments, we do not believe it is appropriate to immediately recognize all expected losses on financial assets at the time of origination or acquisition or when such estimates change as would be required by the proposal. We support timely recognition of credit losses; however, there is an important distinction between expected losses and actual losses. Actual losses (e.g., those known or identifiable) should be recognized immediately. However, losses expected to occur over the life of a financial asset, and which are estimated without a probability trigger, should be recognized over the asset's life, because immediate recognition of all expected losses ignores the business practice of pricing some level of credit risk into the terms of the financial asset and the economic reality that such losses do not occur immediately. ¹⁴

In addition, we believe in certain circumstances the proposal may actually result in later credit loss recognition than under current practice. The proposal's requirement to consider only past events and existing conditions, and to presume that existing economic conditions as of the impairment assessment date remain unchanged for the remaining lives of the financial assets, does not reflect the reality of economic cycles and may understate or overstate actual credit losses within a portfolio. At the top of a credit cycle when losses are very low, it is neither realistic nor prudent to assume there will not be an economic downturn and therefore recognize minimal credit losses. Conversely, at the bottom of a credit cycle, it is not realistic to assume conditions will never improve especially when economic forecasts and indicators point toward a recovery. ¹⁵

¹⁴ Question 38

¹³ Question 16

¹⁵ Question 44



We support the development of an alternative model that would meet the objective of more timely recognition of credit losses, while providing more relevant information to users and reducing complexity in financial reporting. Our alternative model would utilize aspects of both the FASB's proposed model as well as the model proposed in the IASB's ED/2009/12. Consistent with our views articulated above on the classification and measurement model, our alternative impairment model would be applied to financial assets measured at amortized cost and equity securities measured at their redemption amount.

The following describes in more detail the characteristics of our alternative impairment model.

Timing of Loss Recognition

Expected credit losses over the life of a financial asset would be estimated without a probability trigger consistent with the FASB's proposal and would be determined at the time the asset is originated or acquired. Those expected losses would be recognized throughout the asset's life. All actual losses (e.g., losses that are known or identifiable) would be recognized as credit impairment losses in the period in which they are identified, and expected losses would be reforecast and recognized over the financial instrument's remaining life. The combination of recognizing expected credit losses over the asset's life and recognizing actual losses immediately would result in earlier recognition of credit losses compared to the incurred loss model. Further, recognizing expected credit losses over the life of the financial asset would prevent the financial statement distortion that would result from the FASB's proposed model, in which all credit impairment losses would be recognized immediately. Immediate recognition of losses expected to occur over the life of a financial asset is not consistent with the business practice of pricing some level of credit risk into the terms of the financial asset and the economic reality that such losses do not occur immediately. The end result of our alternative model for recognizing credit losses would be an expected loss model with a floor representing actual losses. 16

For example, if an entity originates a five-year loan and recognizes the expected losses over the loan's life, but determines that an actual loss occurs in the second year, the loss would be immediately recognized in year two rather than recognizing the actual loss in future periods. After the actual loss is recognized, expected losses would be reforecast and recognized over the remaining life of the loan.

Consideration of Future Conditions

¹⁶ Ouestion 43



When assessing and measuring impairment, our alternative model would require the consideration of future economic conditions for the reasonably foreseeable future (i.e., period during which management believes they can forecast economic conditions with a reasonable degree of reliability). For financial assets with lives extending beyond the reasonably foreseeable future, economic conditions in those later periods would be estimated on the basis of historical averages. Including future conditions in the impairment evaluation would recognize the reality of economic and credit cycles and would result in earlier recognition of credit impairment when economic indicators are weakening.¹⁷

Individual and Collective Impairment Assessments

Similar to the FASB's proposed model, under our alternative model entities would be given latitude to determine whether to assess impairment for financial assets on an individual basis or as part of a pool. Impairment on individually-evaluated financial assets would be measured based on expected cash flows (or fair value of the collateral if the asset is collateral-dependent). If these impairments are considered to be actual losses, which we believe would often be the case, the losses would be recognized immediately; otherwise, the expected losses would be recognized over the life of the asset.

Financial assets that are individually evaluated for impairment and determined to not be impaired would be evaluated for impairment as part of a pool of similar financial assets. Impairment would be measured for a group of similar financial assets by applying a historical loss rate (adjusted as necessary for reliable information about existing and future conditions that is not reflected in the historical loss rate) to the principal balance of the pool. Guidance would be necessary on how to determine a historical loss rate that represents expected losses over the life of the financial assets rather than losses measured over a shorter time horizon (e.g., an annual loss rate). ¹⁸

Interest Income Recognition

Consistent with the FASB's proposal, interest income would be recognized based on the financial asset's amortized cost less the allowance for credit losses. This approach is consistent with current IFRSs and thus would be a step toward convergence which we support. As per the proposal, accrual of interest income would cease on a financial asset when expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative. ¹⁹

¹⁸ Questions 40, 42, 45, and 47

¹⁷ Ouestion 44

¹⁹ Questions 48 and 55



However, we ask the FASB to seek financial statement users' (including regulators) input on this approach since we understand contractual interest income and non-accrual levels are used currently as benchmark measures, including those of asset quality. In addition, application guidance should be provided to address how the interest income recognition approach could be applied to groups of financial assets such as when these assets are evaluated for impairment on a pool basis.²⁰

Definition of a Write-off

Consistent with the FASB's proposal, a financial asset would be written off in the period in which the entity has no reasonable expectation of recovery. Entities would not delay write-offs until the point in time where it has exhausted its collection efforts.

Hedge Accounting

In view of the fact that the IASB has not completed its deliberations or issued a proposal on hedge accounting, we are not in a position to finalize our comments on the FASB's proposal until we have had the opportunity to analyze and consult thoroughly within our international network on the IASB's proposal. However, given that the accounting for derivative instruments and hedging activities under GAAP and IFRSs have many similarities and any difference between the models developed on this topic would represent significant convergence issues, we reiterate the importance of the development of a high-quality, converged standard related to hedge accounting. The following represents our preliminary views on the proposed changes to hedge accounting included in the FASB's proposal.

We support the proposal's changes to the assessment of hedge effectiveness to require (1) that a hedging relationship be reasonably effective (rather than highly effective), (2) a qualitative assessment of the effectiveness of a hedging relationship at inception (unless a quantitative assessment is necessary based on facts and circumstances), (3) no ongoing assessment of effectiveness, unless facts and circumstances suggest that the hedging relationship would no longer be reasonably effective and (4) no assumption of perfect effectiveness.²¹

We also support the use of a single hypothetical derivative for purposes of the assessment of effectiveness and measurement of ineffectiveness in a cash flow hedge of a group of transactions occurring within a specific time frame if it settles within a reasonable period of time from the settlement of the hedged transactions. In addition, we agree with the proposal that entities should be permitted to use total changes in cash flows or intrinsic

²⁰ Questions 52 and 55

²¹ Questions 56 and 57



value when measuring ineffectiveness related to a purchased option used as the hedging instrument in a cash flow hedge. Also, if total changes in the purchased option's cash flows are used, we support the amortization of the time value component of the purchased option beginning earlier than current practice.

We do not agree with the proposal's limitation on an entity's ability to dedesignate a hedging relationship. We do not understand the FASB's conceptual basis for this change and we are not aware of any current practice issues that would call for such a change. In addition, we believe that the effective termination guidance is complex, unclear, and will not be applied consistently.²²

We also do not agree with the proposed change that would require entities to record in earnings ineffectiveness related to underhedges for cash flow hedging relationships. This change would require gains or losses on a hypothetical derivative (representing the forecasted transaction) to be recognized in earnings with an offset to OCI. This proposed change is in direct contrast to the FASB's conceptual basis for not requiring entities to record ineffectiveness related to underhedges in a cash flow hedging relationship as described in paragraphs 379 and 380 of Statement 133 with which we agree. That guidance indicates that entities should not defer in OCI a nonexistent gain or loss on a derivative and recognize in earnings an offsetting nonexistent loss or gain when the change in the present value of the expected future cash flows of the hedged transaction exceeds the change in the present value of the expected cash flows on the hedging derivative. We believe those gains or losses are, at best, opportunity gains and losses.²³

In addition, although not included in the FASB's proposal, we would support allowing measurable and quantifiable components of nonfinancial instruments to be designated as the hedged risk in a fair value or cash flow hedge. Many components of nonfinancial instruments can be measured and quantified in the same manner as components in financial instruments such as changes in cash flows or fair value due to changes in a benchmark interest rate.

The Appendix to this letter provides our comments on the proposed amendments that the FASB should consider if it decides to finalize the guidance as proposed.

A comprehensive list of updates to the Accounting Standards Codification (ASC) related to the proposal has not yet been issued by the FASB. We may submit an addendum to this letter at a later date to address comments specific to the forthcoming proposed ASC updates.

²² Ouestion 63

²³ Question 61



* * * * *

We would be happy to further discuss these issues at the request of the FASB or the staff. A copy of this letter also is being provided to the IASB.

Sincerely,





Appendix

Proposed Accounting Standards Update, "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities" (File Reference No. 1810-100)

As stated in our cover letter, we support the FASB's efforts to reduce complexity and respond to calls to provide investors with more useful, transparent, and relevant information about an entity's financial assets and financial liabilities; however, we do not support the finalization of the proposal as currently drafted. Instead, we support the development of a mixed-attribute classification and measurement model in which the financial assets an entity plans to hold to collect contractual cash flows that consist of payments of principal and interest on specified dates and all financial liabilities (except for derivative instruments and financial liabilities held for trading) would be measured at amortized cost, rather than fair value. In addition, we support the development of an alternative impairment model that would utilize aspects of both the FASB's proposed model and the model proposed in the IASB's ED/2009/12.

These views have not been reiterated in this Appendix. This Appendix provides our comments on the proposed amendments that the FASB should consider if it decides to finalize the guidance as proposed. Our comments are focused on minimizing implementation complexities and ensuring that the proposal is understandable to preparers and useful to financial statement users.

Classification and Measurement

Financial Instruments for Which Qualifying Changes in Fair Value are Recognized in Other Comprehensive Income (FVTOCI)

<u>Scope</u>

The type of debt instruments that may qualify for the FVTOCI election is unclear. We suggest that the proposal more clearly indicate that the FVTOCI election would be available to all debt instruments, including investments in debt securities (i.e., financial assets) and an entity's own issued debt (i.e., financial liabilities).

Qualifying Criteria¹

We believe that one of the more significant challenges associated with the adoption of the proposal is whether entities would be able to operationalize and consistently apply the proposed criteria for recognizing qualifying changes in fair value in OCI. As currently drafted, we do not believe that the criteria are sufficiently clear to produce consistent results. Our concerns related to the cash flow and business strategy criteria are as follows:

¹ Question 28



Cash Flow Criteria

Paragraph 21(a)(1) states that in order for a debt instrument to qualify for the FVTOCI election, the debt instrument must have an "...amount transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement, which is the principal amount of the contract adjusted by any original issue discount or premium." However, the proposal is not clear whether the form of the amount transferred to the investor at maturity or settlement would impact if a financial instrument would meet paragraph 21(a)(1). For example, paragraph IG65 indicates that the issuer of convertible debt would not be eligible to classify the instrument as FVTOCI because the convertible debt's principal will not be returned to the investor at maturity or other settlement if the investor exercises its conversion option. That guidance appears to indicate that the potential for the principal amount of the debt to be settled in any form other than cash would cause the instrument to not meet paragraph 21(a)(1) regardless of the probability of non-cash settlement. If the FASB intends to preclude instruments with principal amounts that may be settled in a form other than cash from meeting paragraph 21(a)(1), we believe that this point should be clarified in the proposal as it would also potentially impact financial instruments other than convertible debt, such as debt instruments that could be rolled over at maturity because a rollover could be deemed a non-cash settlement.²

The proposal states that a debt instrument would not be required to have contractual interim cash flows in order to meet paragraph 21(a)(2), which requires that "The contractual terms of the debt instrument identify any additional contractual cash flows to be paid to the creditor (investor) either periodically or at the end of the instrument's term." However, it is not clear whether payment of a return on principal (i.e., interest) is required to meet paragraph 21(a)(2). We believe that this issue should be clarified in the proposal.

In addition, we believe that additional guidance is necessary to understand the classification of the perpetual instrument described in Example 14 (paragraphs IG73 and IG74) and other perpetual instruments. The proposal indicates that the perpetual instrument would not meet the FVTOCI cash flow criteria, and would therefore be classified as FVTNI; however, the proposal does not identify which cash flow criteria would not be met. The indeterminate nature of this conclusion raises a number of application questions including (a) whether interest payments received on a perpetual instrument throughout its life or the cash received upon the exercise of a put option would be considered a return of the principal amount at 'other settlement' under paragraph 21(a)(1) and (b) whether the nonaccrual of interest on the deferred interest amounts as described in the example would cause the perpetual instrument to not meet

² Question 21



paragraph 21(a)(2). Therefore, the proposal should more clearly indicate the basis for the conclusion that the perpetual instrument described in Example 14 would not meet the cash flow criteria to facilitate the consistent evaluation of perpetual or similar instruments.

Business Strategy Criterion

The proposal indicates that because an entity's business strategy is not required to be evaluated at a reporting entity level, entities may conclude that they have more than one business strategy. Although the proposal provides an example where more than one business strategy exists (e.g., trading desk vs. other operations), we believe that entities may have difficulty determining how granular a business strategy may be defined. Many insurance companies manage their businesses using an asset-liability management model based on its different product lines. Since financial assets purchased by the insurance company are designed to provide funding for expected payouts on claims for a specific product, these entities may conclude that the business strategy for the financial assets related to each product line would be different, even though similar assets may be used to provide funding for different product lines. Due to the significant impact this may have on the classification of financial instruments, if the FASB believes that an entity's business strategy is intended to be evaluated at a higher level than product line (or other granular basis), we suggest that the proposal provide additional guidance related to the appropriate level at which to evaluate an entity's business strategies.

Although the proposal clarifies that the evaluation of an entity's business strategy would be based on how the entity manages its financial instruments on a portfolio basis rather than on the entity's intent for an individual financial instrument, we believe that entities may interpret that the business strategy criterion should be evaluated at the individual instrument level because paragraph 21(b) refers to the entity's business strategy *for the instrument*. We believe that the FASB should clarify in paragraph 21(b) that the business strategy for the instrument is based on the entity's business strategy for the instrument and other financial instruments when evaluated on a portfolio basis.

Transaction Fees and Costs

We believe that the proposed changes to the accounting for transaction fees and costs for financial instruments classified as FVTOCI may create significant operational challenges. For example, consistent with current GAAP, the proposal would require certain loan origination fees, net of direct origination costs, to be deferred and amortized into interest income over the life of the instrument. However, as these fees would be recognized in OCI on the date of first remeasurement rather than being recorded on the statement of financial position as part of the loan basis (as required by current GAAP), this change would effectively delay the start of the amortization of these fees from the inception of



the loan to the end of the first reporting period subsequent to inception. If the FASB's intent is to delay the amortization of these fees, the proposal should provide the conceptual basis for this decision because there does not appear to be a practical need for the change and it may result in entities having to make changes to their information systems.

Additionally, the proposal's requirement that all transaction fees and costs related to debt instruments classified as FVTOCI (other than certain loan origination fees) be recognized in earnings at issuance would represent a significant change from current practice and would create a difference in the accounting for costs to originate loans and issue debt. The proposal would require entities to expense all debt issuance costs at inception, while it would require that certain loan origination fees be deferred and amortized into interest income over the life of the instrument. We do not believe that costs to originate loans should be accounted for differently from costs to issue debt. If the FASB believes that there is an important difference between the accounting for costs associated with a loan issuance versus issued debt that requires different accounting results, we believe that rationale should be provided in the proposal.³

Deferral of Origination Fees that Reduce a Loan's Interest Rate

Loans classified as FVTOCI for which there is not a significant difference between transaction price and fair value would be initially measured at their transaction price. Paragraphs 78 and IG19 of the proposal indicate that loan origination fees, net of direct origination costs, would be deferred in accumulated OCI at the time of the first subsequent remeasurement. Additionally, the Master Glossary definition of loan origination fees includes fees paid by the borrower to reduce the effective interest rate on the loan, which evidences the FASB's intention that such fees are to be deferred and amortized into interest income over the life of the loan. However, we believe that the mechanics of deferring loan origination fees that are paid to reduce the loan's interest rate would result in accounting entries that are inconsistent with the FASB's stated intention.

Paragraphs IG17 through IG19 provide an example of how fees paid to reduce the loan's interest rate would be deferred. However, this example presumes that the fair value at the time of subsequent remeasurement is the same as the principal amount of the loan. If there have been no changes in market factors that would affect the loan's fair value from the time of origination, we believe that the example's presumption is incorrect because it ignores the fact that the rate was reduced below a market interest rate. In the example, assuming that the \$544 fee paid represents the decline in fair value due to the lower interest rate, the fair value of the loan at the time of remeasurement would not be the

³ Question 11



original \$10,000 principal. Rather, it would be \$9,456 because market participants would pay less for a loan that bears a below-market rate of interest.

We believe that the logic surrounding this example illustrates that the method by which buy-down fees would be deferred (at the time of the first subsequent remeasurement to fair value) would not result in those fees actually being deferred because the fair value of the loan would presumably be less than the principal amount by the amount of the fee paid. We suggest that the FASB reevaluate its method for deferring loan origination fees, as well as the associated example to illustrate how such fees would be deferred.

Financial Liabilities Measured at Amortized Cost⁴

We believe that the proposed criteria to qualify for measuring a financial liability at amortized cost, specifically the measurement attribute mismatch criteria, should be modified to eliminate any 'bright-line' quantitative thresholds and clarified to eliminate certain application issues.

The proposal's quantitative threshold would result in scenarios where depending on whether more or less than 50 percent of an operating segment's or consolidated entity's recognized assets are subsequently measured at fair value (1) similar financial liabilities of the same entity would have different measurement attributes and/or (2) similar financial liabilities of similar types of entities would have different measurement attributes even though the business model for the liabilities in all circumstances is the same. We believe that this quantitative threshold (or any quantitative threshold) creates an arbitrary differentiation that may result in providing less useful or even potentially misleading information to financial statement users.

Therefore, we support the elimination of a 'bright-line' quantitative threshold and the development of a principles-based approach to determine whether a measurement attribute mismatch exists. Entities would need to apply judgment. A similar approach is applied by entities that elect the fair value option under IAS 39.5

However, if the FASB retains the measurement attribute mismatch criteria as drafted, we believe that the FASB should clarify that in order for the quantitative threshold to be met at the segment level, the segment must qualify as an operating segment. The definition of an operating segment in FASB ASC paragraph 280-10-50-1 requires, in addition to other conditions, that the segment's "operating results are regularly reviewed by the public entity's decision maker to make decisions about resources to be allocated to the segment

⁴ Ouestions 18 and 30

⁵ International Accounting Standard No. 39, Financial Instruments: Recognition and Measurement



and assess its performance." Because paragraph 30(b) of the proposal states that "The financial instrument is issued by and recorded in, or evaluated by the chief operating decision-maker as part of an operating segment..." instead of stating that "The financial instrument is issued by and recorded in, and evaluated by the chief operating decisionmaker of an operating segment...", it appears that a financial liability that is issued by and recorded as part of a segment would not be required to be evaluated by the chief operating decision-maker and therefore the segment would not be required to meet the definition of an operating segment under current GAAP. We do not believe that was the FASB's intention; therefore, we suggest that the FASB clarify this guidance to avoid structuring opportunities such as the establishment of new subsidiaries that do not meet the definition of an operating segment and that are established solely to hold nonfinancial assets and issue bonds that would not otherwise meet this measurement attribute mismatch criterion.

Measurement Guidance When Transaction Price is Significantly Different from Fair

The proposal is not sufficiently clear regarding when entities are required to determine if a significant difference exists between the transaction price and fair value of a financial instrument classified as FVTOCI or amortized cost. Paragraph 14 of the proposal implies that entities would complete this evaluation only when they expect that a significant difference exists. However, paragraph IG7 states that entities must determine whether reliable evidence exists that there is a significant difference between transaction price and fair value at initial recognition, which implies that this evaluation must be completed at inception for every financial instrument. We believe that the FASB should clarify when this evaluation must be completed to promote consistent application.

Hybrid Financial Instruments⁷

The proposal would require that all hybrid financial instruments that contain embedded derivative features that require separation under current GAAP be classified in their entirety at FVTNI. We believe that this would result in situations where embedded derivatives that effectively do not impact current reported financial information would significantly impact the financial reporting for hybrid financial instruments under the proposal.

There are embedded derivative features that are required to be separated by current GAAP, but because the value of the embedded derivative is de minimus, entities may not record the embedded derivative. For example, hybrid financial instruments with

⁶ Ouestion 12

⁷ Question 25



embedded features that are triggered only upon the occurrence of an event and the probability of that event occurring is remote (e.g., a note issued at par that is puttable at a substantial premium upon an initial public offering, adverse developments in tax law, or change in control) would not significantly impact financial reporting today because the value of the embedded derivative may be considered de minimus, but the existence of these embedded features would cause the hybrid financial instrument to be classified as FVTNI under the proposal.

We believe that embedded derivative features that would have only a de minimus impact on a hybrid financial instrument should not affect the classification of the hybrid financial instrument in its entirety. Therefore, if the FASB decides to move forward with the proposed changes, we believe further clarification may be beneficial to allow entities to apply judgment to determine whether embedded derivative features that are required to be separated under current GAAP that would have only a de minimus impact on the hybrid financial instrument would cause the entire hybrid financial instrument to be classified as FVTNI.

Interaction with FASB Project on Financial Instruments with Characteristics of Equity⁸

We are concerned that the proposal's conclusion that the issuer of convertible debt would be required to classify the debt as FVTNI because it would not meet the FVTOCI cash flow criteria anticipates decisions that would be made in the FASB's project on the accounting for Financial Instruments with Characteristics of Equity. The proposal's conclusion implies that physically settled written options on an entity's own equity would be classified as liabilities. We request that the FASB consider the impact of this proposed change on the existing FASB project prior to reaching a definitive conclusion in the context of this proposal.

Specialized Measurement Guidance

Loan Commitments and Financial Standby Letters of Credit

The proposal states that loan commitments and standby letters of credit (with limited exceptions) would be recognized on the statement of financial position at fair value. However, the proposed guidance, including the examples within the implementation guidance, does not address the portion of the commitment's fair value related to servicing.

SEC Staff Accounting Bulletin No. 109, Written Loan Commitments Recorded at Fair Value Through Earnings, requires that the fair value measurement of a loan commitment

_

⁸ Question 21



include the expected net future cash flows related to the associated servicing of the loan. We understand that servicing value is generally included in fair value measurements of loan commitments in current practice and the proposal would not change existing practice. However, because the proposal would result in significantly more loan commitments being recognized at fair value, we believe it is important for the proposed guidance to highlight this fact. We believe the FASB should revise the examples in the implementation guidance to highlight the need to include the servicing component in a loan commitment's fair value.

Example 18 of the proposal (beginning at paragraph IG87) provides implementation guidance on accounting for loan commitments under the proposal. The usefulness of this example is limited, and we believe in some cases the example may result in inappropriate application of the proposed guidance, for several reasons:

- The journal entries illustrating the exercise of the commitment, resulting in a funded loan, appear to be incorrect. For example, paragraphs IG93 and IG101 say that the funded loan is initially recorded at its fair value of \$98,500. However, from the time the commitment was issued, changes in market interest rates have only reduced the value of the \$100,000 loan by \$500, not \$1,500. The \$98,500 "fair value" was calculated as the principal amount less the fair value of the commitment on the statement of financial position, which does not reflect the fact that a market participant would ascribe a fair value of \$99,500 to the loan (absent other factors). The manner in which the "fair value" was determined in the example is incorrect because the time value of the commitment would have decreased over time, and would be zero at the time the option is exercised.
- As noted previously, we believe a fair value measurement of a loan commitment would result in the inclusion of value associated with servicing. The example does not illustrate how servicing value would be considered when determining the fair value of a commitment.
- Inherent in any fair value measurement of loan commitments is an assumption of the probability that a commitment will result in a funded loan. This concept is referred to in paragraph BC133, but is not otherwise described in the proposal. The examples in the implementation guidance are written in the context of a single loan, presumably with a 100% probability of funding. We believe the FASB should bring forward the discussion of the probability assessment into the proposed guidance, and also suggest that the FASB revise the proposed examples to illustrate how entities might consider the probability of funding in the context of larger portfolios of commitments.



Core-Deposit Liabilities⁹

We do not support the proposal to remeasure core-deposit liabilities at their remeasurement amount and recommend that the FASB retain amortized cost as their measurement attribute. The concept of the remeasurement amount proposed is complex and its calculation is subject to a significant degree of judgment. This amount would provide financial statement users with neither information sufficient to understand contractual cash flows of the core-deposit liabilities nor information about their fair value. The proposal states that the remeasurement amount of core-deposit liabilities is not intended to represent fair value, and as a result the assumptions used to determine the remeasurement amount do not consider assumptions that market participants would use in pricing the core-deposit liabilities. We believe that the appropriate measurement attributes for financial instruments are amortized cost or fair value, depending upon an entity's business model for the financial instruments. The creation of a new measurement attribute that disregards both the relevance of amortized cost information and the perspective of market participants adds unwarranted complexity. As a result, we believe the proposed remeasurement amount approach would not provide users of the financial statements with useful and relevant information, and would reduce comparability among entities.

Should the FASB proceed with the proposal to remeasure core-deposit liabilities at the remeasurement amount, we recommend the following revisions to the proposed guidance:

Determination of the Remeasurement Amount

The proposal does not specify how the average core-deposit amount during the period is to be determined. The proposal does not state whether the "period" referred to is a historical period based on actual core-deposit volumes, or rather an estimate of future deposit balances. If the intent is for the average to be determined using a historical lookback, the "period" needs to be more clearly defined (e.g., fiscal year-to-date, interim period, rolling 12-month period) so that entities can consistently determine the remeasurement amount.

It is unclear why the starting point of the calculation uses an average amount rather than the amount of recognized core deposits at the remeasurement date. The proposal should explain the rationale for basing a financial statement measurement on an amount other than the amount of recognized core-deposit liabilities since issues may arise by using this approach. For example, assuming the "period" over which core-deposit liabilities are averaged is based on a historical period, a bank experiencing consistent deposit growth

_

⁹ Questions 17 and 31



would use an average amount in the calculation that is less than the amount of coredeposit liabilities recognized at the remeasurement date. To the extent of that difference, the proposed remeasurement amount approach would ignore the liabilities that exist at the remeasurement date and any benefits provided by those liabilities.

All-in-Cost-to-Service-Rate

The proposal would define the all-in-cost-to-service rate as a rate that includes the net direct costs to service core deposits. This definition appears to be inconsistent with paragraph IG24, which would include many types of costs that are generally not considered to be direct costs to service the deposits, such as rent, building depreciation, utilities, and advertising.

The proposal does not address how core-deposit liabilities would be remeasured when the all-in-cost-to-service rate exceeds the alternative funds rate. When the significant amount of operating expenses included in the all-in-cost-to-service rate is combined with a low interest rate environment that decreases the alternative funds rate, we believe it may be common for a negative discount rate to result. The proposal should provide additional guidance on how core-deposit liabilities would be remeasured in that circumstance.

Interaction with Accounting for Core Deposit Intangible Assets

The proposal does not address how the remeasurement amount of core-deposit liabilities interacts with current practice for recognizing a core-deposit intangible asset when deposit liabilities are assumed, such as in a business combination.

When a bank assumes core-deposit liabilities in a business combination, a core-deposit intangible asset is generally recognized. This intangible asset represents the benefit provided by the customer relationship, including the stable low-cost funding source. Although we believe the calculation of the low-cost funding benefit for the core-deposit intangible asset differs from how that benefit would be calculated in the remeasurement amount of the core-deposit liabilities, application of the proposed guidance may result in the low-cost funding benefit being recognized twice in the statement of financial position (once as a component of the core-deposit intangible asset, and again as a reduction of the carrying amount of the core-deposit liabilities). The proposal is not clear as to how any double-counting of that benefit should be eliminated, because it currently neither requires derecognition of a portion of the core-deposit intangible asset nor provides guidance on how to determine the amount to derecognize considering that the benefit is calculated differently in each model.



Short-Term Receivables and Payables

We believe the proposal may unintentionally result in most customer receivables and vendor payables not qualifying for amortized cost measurement. One of the requirements for short-term receivables and payables to qualify for amortized cost measurement is that the receivables and payables must meet the criteria for FVTOCI classification.

To qualify for FVTOCI classification, the proposal requires, in part, the financial instrument to have an amount that is transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement. Paragraph IG27 states that there must be an "upfront transfer of funds that is an initial investment of the principal amount." Thus, it would appear that short-term trade receivables and vendor payables may not qualify because goods or services are transferred to the debtor, and there is not a transfer of funds.

Paragraph IG49 contains an example in which it is determined that trade receivables qualify for amortized cost measurement without any analysis of the cash flow characteristics of the receivables. Based on that example, we do not believe that the FASB intends to preclude amortized cost measurement for most types of basic short-term receivables or payables solely due to this criterion, and accordingly the FASB should consider revising the criteria for amortized cost measurement of short-term payables and receivables.

Equity Method of Accounting 10

We do not support the addition of a new criterion that the operations of the investee must be considered related to the investor's consolidated operations in order for the investor to account for its equity investment in the investee under the equity method of accounting. Given that the equity method of accounting is essentially a one-line method of consolidation when an entity does not have control over an investee, but has significant influence, and because control or significant influence does not depend on whether an investee's operations are considered related to the parent's operations, we do not understand why it would be appropriate to add this criterion to qualify for the equity method of accounting.

We believe that many investments that were previously accounted for under the equity method would be classified as FVTNI if this change were made. This represents a significant change from current GAAP; however, the FASB does not provide sufficient justification for this change in the basis for conclusions. If the FASB wishes to change

¹⁰ Question 4



the criteria for the equity method of accounting, we recommend it be done in a separate project.

Presentation

Changes in an Entity's Own Credit Standing¹¹

We do not support either of the methods presented in Appendix B of the proposal for determining the amount of the change in the fair value of a financial liability attributable to changes in the entity's own credit standing. Method 1 is based on the premise that if there were no change in an entity's credit rating during the period, the entity would assume that there were no changes in fair value during the period related to a change in the entity's credit standing, excluding the price of credit risk. We do not believe that an entity's credit standing should be considered synonymous with an entity's credit rating determined by rating agencies because credit ratings may be lagging indicators of credit quality. In addition, we believe that many entities would face significant operational challenges applying Method 2 because the entity would be required to estimate the change in the price of credit by looking to other entities in the same industry with the same credit rating. Certain industries may have a limited number of entities to consider as its population to obtain the requisite information because not all entities have issued debt that is rated by a rating agency and even fewer would have the same rating as the entity performing the calculation.

Impairment

Inability to Use Future Events and Conditions in the Impairment Evaluation¹²

The proposal's prohibition to consider future events or conditions may be difficult to operationalize. We believe that in many instances it will be difficult to distinguish between existing conditions and future conditions because of interrelationships between the two. Many economic indicators that might be considered in an impairment evaluation (e.g., unemployment rates) can be reasonably expected to impact other assumptions in an impairment evaluation (e.g., probability of default) on a lag. When there is a historical relationship between economic conditions, distinguishing between which conditions exist and which conditions are forecasts creates an artificial separation of the economic reality that exists at the impairment evaluation date.

We understand that the FASB is aware of this potential operational difficulty, and the proposal includes examples that attempt to illustrate how the guidance would be applied.

¹¹ Questions 33 and 34

¹² Question 46



However, the examples provided are relatively simple and do not clearly illustrate situations in which existing conditions are closely interrelated with future conditions. In practice the distinctions will not be as apparent.

In addition, the inability to consider future conditions in an impairment assessment may increase the operational burden on preparers and provide financial statement users with inconsistent information in different contexts in the financial statements. We believe these practice issues will result because of a disconnect between how credit losses would be estimated for purposes of the impairment model and how credit losses are estimated when determining fair value.

Under the proposal, substantially all of the financial assets that would be subject to the proposed impairment model would be recognized at fair value in the statement of financial position. When determining fair value, entities would need to consider the assumptions that market participants would use in pricing the financial asset. Market participant assumptions generally include estimates of future conditions (e.g., interest rates and credit loss rates), and those assumptions would need to be considered by the entity when determining fair value.

However, for purposes of assessing and measuring credit impairment, the use of forward-looking assumptions would be prohibited. As a result, financial statement preparers may find it necessary to produce different sets of cash flows. One set of cash flow projections (including forecasts of future conditions) may be necessary for fair value purposes, with a separate set of cash flow projections (excluding forecasts of future conditions) necessary to evaluate the financial assets for impairment.

The use of different assumptions for measuring fair value and measuring credit impairment may also provide conflicting and potentially confusing information to financial statement users.

Appropriateness of the Allowance for Each Class of Financial Asset

Paragraph IG114 of the proposal requires the allowance for credit losses to be appropriate to cover the entity's expected credit losses for each class of financial asset. This guidance would appear to require the allowance for credit losses to be determined at the class level.

This guidance seems contradictory with current GAAP. ASU 2010-20, *Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, defines a portfolio segment as the level of disaggregation at which an entity documents and develops a systematic methodology for determining its allowance for credit losses. The requirement in the proposal to determine the appropriateness of the allowance for credit



losses at the class level would appear to require the allowance for credit losses to be determined at an even more disaggregated level.

In addition, the notion of a class is not further defined nor discussed in the proposal. Current GAAP contains descriptions of classes (e.g., level of disaggregation for fair value disclosures, level of disaggregation for credit quality information about financing receivables) that may be analogized to for purposes of applying the proposed guidance. However, the guidance for determining appropriate classes in other GAAP differs depending upon the context for which the class is determined.

The FASB should revise the proposed guidance to eliminate apparent inconsistencies with other GAAP and to ensure consistent application of the class notion in the proposal.

Variable-Rate Financial Assets

The proposal provides specific guidance for determining the interest rate used to estimate cash flows of variable-rate financial assets. The proposed guidance would require entities to recalculate the expected cash flows over the lives of the financial assets to reflect the variable rate or index in effect at each reporting date, and would preclude entities from forecasting future changes in the index or variable rate. Similar guidance is proposed in the context of determining the effective interest rate on variable-rate financial assets.

In applying this proposed guidance, we believe questions may arise as to whether it is appropriate to use a spot rate or the forward interest rate curve as of the reporting date. We believe either method would be consistent with the proposed guidance, as neither the spot rate nor the forward curve includes a projection of future interest rate changes. However, we suggest that the FASB clarify this requirement.

Application of Impairment Model to Investments That Can Be Redeemed Only for a Specified Amount

The types of equity securities that the FASB intends to qualify for measurement at their redemption amount typically have neither a stated maturity nor contractual cash flows paid to the investor. Accordingly, the discounted cash flow method for evaluating impairment for such an investment individually may not be operational. In addition, because these types of equity securities are generally unique in nature, it is unclear how they could be evaluated for impairment as part of a collective assessment. The FASB should provide guidance specific to assessing impairment on equity securities measured at their redemption amount.



Interest Income Recognition

Collectability of Contractual Accrued Interest Receivable

Under the proposal, the difference between the amount of interest contractually due and the amount of interest income recognized is recorded as an increase to the allowance for credit losses. Although the proposal is not explicit, we believe entities would continue to accrue contractually-due interest as an asset in the statement of financial position. At each reporting date, entities would adjust the allowance for credit losses to reflect the entity's estimate of cash flows not expected to be collected.

To the extent the contractual interest is unpaid, the proposal does not provide guidance on how entities should evaluate the collectability of the accrued contractual interest receivable. In theory the interest cash flows not expected to be collected would have already been reflected as an increase to the allowance for credit losses. However, absent specific guidance, when entities "true up" the ending balance of the allowance, it may be possible to overlook the accrued contractual interest receivable when determining the appropriate level of the allowance for credit losses. If that occurred, the allowance for credit losses may be insufficient. We suggest the FASB include clarifying language to help ensure entities are also appropriately evaluating the collectability of any accrued contractual interest receivable.

Ceasing Accrual of Interest Income

We believe additional guidance is necessary on how the cessation of accrual of interest income would be applied to financial assets that are evaluated for impairment as part of a pool. The proposed guidance would require an entity to cease accruing interest income when the expected cash flows would indicate a negative yield on the financial asset. Neither the proposal nor current GAAP contain requirements for determining expected cash flows on financial assets that are evaluated collectively for impairment. In fact, the proposal would require a historical loss rate to be used to evaluate impairment for these assets rather than the expected cash flow approach that is required for individually-evaluated financial assets

Hedge Accounting

Hedged Risk

We support the FASB's decision to continue to allow entities to hedge specific risks related to financial assets or financial liabilities. In addition, we would also support allowing measurable and quantifiable components of nonfinancial instruments to be designated as the hedged risk in a fair value or cash flow hedge because many



components of nonfinancial instruments can be measured and quantified in the same manner as components in financial instruments (such as changes in cash flows or fair value due to changes in a benchmark interest rate).

Hedge Effectiveness Requirements

We support the proposed changes to require (a) that a hedging relationship be *reasonably effective* (rather than highly effective), (b) a qualitative assessment of the effectiveness of a hedging relationship at inception and (c) no ongoing assessment of effectiveness, unless facts and circumstances suggest that the hedging relationship would no longer be reasonably effective. However, we are concerned that the proposed changes may not be applied in a consistent manner and therefore, may not provide comparable results among entities. In addition, the proposal's changes would affect long established positions. Therefore, although we understand and support the FASB's position not to provide bright lines, we believe that the FASB should consider providing application guidance in the form of the considerations to be assessed in making determinations related to the following:

- Whether a hedging relationship is reasonably effective
- When a quantitative assessment may be necessary at inception of a hedging relationship and
- When a reassessment (either qualitative or quantitative) may be necessary after hedge inception. ¹³

In addition, although we support the elimination of an entity's ability to assume perfect effectiveness, given the significant impact this proposed change would have on current practice for certain entities, we believe that the proposal should provide transition guidance for existing relationships for which the shortcut, critical terms match, or terminal value methods are currently applied. The following alternatives could be considered: (1) permit entities to grandfather currently eligible hedging relationships, (2) permit entities to update hedge documentation to reflect the use of the long-haul approach and continue the same hedging relationship, or (3) require entities to dedesignate and redesignate new hedging relationships using a long-haul approach after the proposal becomes effective.

Also, while we support the use of a single hypothetical derivative for purposes of the assessment of effectiveness (and measurement of ineffectiveness) in a cash flow hedge of a group of transactions occurring within a specific time frame, we believe that the FASB should consider providing additional guidance related to what would be acceptable as a

¹³ Ouestion 62



"minimal" difference between the forward rates on the hypothetical derivative and the derivative(s) that would exactly offset changes in the forecasted transactions' cash flows.

Dedesignation of Hedging Relationship

We do not agree with the proposed limitation on an entity's ability to dedesignate a hedging relationship. The FASB has indicated that it does not believe that dedesignation should be used as a tool for changing measurement attributes and/or managing the classification of certain items reported in earnings. This view is inconsistent with the intent-based hedge accounting guidance in ASC Topic 815. In addition, this view results in the accounting for the designation and dedesignation of hedging relationships to be based on different principles. For example, the proposal does not limit an entity's ability to designate a hedging relationship even when that relationship includes a derivative instrument that was previously in a trading portfolio; however, it would require that dedesignation may only result if an economic change (actual termination or effective termination) occurs. We do not believe that the proposal is clear why a distinction should be made between these situations.

We believe that the proposed change would prohibit entities from entering into certain types of dynamic hedging strategies, such as when an entity documents that the hedging relationship is a weekly or monthly strategy and enters into a hedging derivative with similar terms, but the entity dedesignates and redesignates the hedging relationship on a more frequent basis (e.g., daily or weekly). However, the proposal is not clear if hedging strategies that are originally documented as being daily or weekly (and therefore terminate at the end of each day or week but are immediately reestablished with the same hedged risk, hedged item and hedging strategy) would be affected by the proposed change since the hedging derivative's term is longer than a day or week. Given the pervasiveness of these types of hedging strategies, we believe that the proposal should clarify the type of strategies that would be impacted by the proposed change.¹⁴

In addition, we believe that the effective termination criteria are complex and, as drafted, would be difficult to apply. We do not believe that it is appropriate for this criterion to be dependent on the use of the term "fully offset" which denotes a level of precision that may not be able to be met in practice. For example, if the offsetting derivative is expected to exactly offset all of the cash flows of the original derivative, this would effectively require that entities enter into the offsetting derivative with the same counterparty as the original derivative at off-market terms in order to effectively terminate the original hedging derivative. Instead, we believe that the proposal should allow entities to apply judgment when evaluating whether the terms of an offsetting derivative would result in

¹⁴ Question 63



an effective termination of the original derivative. In order to promote consistent application, we suggest that the proposal clearly indicate that an offsetting derivative would be required to at least offset the existing risks in the original derivative. This would permit entities to apply judgment when evaluating whether this criterion would be met if (1) the notional, strike price, rates, or maturity of the offsetting derivative varies from that of the original derivative, (2) the offsetting derivative includes risks incremental to those included in the original derivative, or (3) the offsetting derivative's counterparty is different than the original derivative's counterparty.¹⁵

The proposal also would require entities to have contemporaneous documentation in place in order to qualify to effectively terminate an existing hedging derivative and would require entities to continuously monitor the original derivative and offsetting derivative to ensure that they are not designated as hedging instruments in any future hedging relationships. We believe that such additional documentation requirements and ongoing monitoring adds unnecessary complexity, is inconsistent with the FASB's objective of simplifying the accounting for hedging activities, and may require changes to entities' financial reporting systems and internal controls. ¹⁵

We also are concerned that the proposed restriction on an entity's ability to dedesignate a hedging relationship would impact hedges of the foreign currency exposure of a net investment in a foreign operation. Under current GAAP, entities are permitted to use either a derivative instrument or a nonderivative financial instrument (e.g., foreign-currency-denominated debt) as the hedging instrument in a net investment hedge. However, because entities would only be able to dedesignate a hedging relationship if it is no longer reasonably effective or if there is a change to the *derivative* hedging instrument, the proposal would appear to effectively prohibit an entity from redesignating a net investment hedging relationship if a nonderivative financial instrument is used as the hedging instrument. If the proposed dedesignation changes are not intended to impact net investment hedging relationships, we believe that the FASB should clarify that fact.

We believe that there currently is diversity in practice related to what events constitute a dedesignation event, for example, in determining whether an addition or removal of a derivative instrument or hedged item from a group of derivative instruments or hedged items would be considered a dedesignation event of a portfolio hedging relationship. However, we do not believe that the proposal provides an enhanced understanding of what constitutes a dedesignation event. For example, the proposal indicates that adding a derivative to an existing hedging relationship that would not fully offset an existing derivative and would not reduce the effectiveness of the hedging relationship would not result in the termination of the hedging relationship. The proposal is not clear why the

¹⁵ Ouestion 64



addition of such a derivative would not be considered a termination of the relationship, especially since it appears that the removal of a similar derivative from a group of derivatives would be considered a termination of the hedging relationship. If the FASB believes that there is an important difference between these two scenarios that causes different accounting results, we believe that information should be provided. Additionally, the proposal should clarify if the guidance related to derivative instruments is also applicable to scenarios where hedged items are added to or removed from a portfolio of hedged items.

Measuring and Reporting Ineffectiveness in Cash Flow Hedging Relationships

We do not agree with the proposed changes related to the measurement of hedge ineffectiveness because we do not agree that entities should be required to record in earnings ineffectiveness related to underhedges for cash flow hedging relationships. We are concerned that gains or losses on a hypothetical derivative (representing the forecasted transaction) would be recognized in earnings with an offset to OCI. As we are not aware of practice issues that have arisen since the issuance of Statement 133 that would require a reevaluation of this core concept, we do not understand why the FASB decided to move away from the conceptual basis discussed in paragraphs 379 and 380 of Statement 133 with which we agree. We believe that the impact on earnings for underhedging in cash flow hedges represents the opportunity cost of using a less than perfect derivative, rather than a change in an actual recorded asset or liability as is the case related to fair value or net investment hedges, and we do not believe it is appropriate to record this impact in earnings. ¹⁶

Similar to our previous discussion on the effective termination criterion, we believe that it is important that the proposal avoid using terms that imply a level of precision that cannot be attained. For example, paragraphs 122 and 124 of the proposal state that "For example, an entity could compare the change in fair value of the actual derivative with the change in fair value of a derivative that would mature on the date of the forecasted transaction, be priced at market, and provide cash flows that would exactly offset the hedged cash flows." We do not believe that the term "exactly" is appropriate to use, as it denotes a level of precision that may not be met. Instead, we believe the proposal should focus on the entity's judgment regarding the terms of the hypothetical derivative that would meet the FASB's stated principles. ¹⁶

The FASB should clarify how the guidance in paragraphs 114 and 124 of the proposal relate to one another. Paragraph 114 of the proposal states that "...an entity shall not ignore whether it will collect the payments it is owed or make the payments it will owe

_

¹⁶ Ouestion 61



under the provisions of the hedging derivative instrument in determining fair value for assessing effectiveness," while paragraph 124 states that "When measuring the ineffectiveness to be reported in earnings by using a derivative that would mature on the date of the forecasted transaction and provide cash flows that would exactly offset the hedged cash flows, an entity may use the same credit risk adjustment as that used in calculating the fair value of the actual derivative hedging instrument." Paragraph 114 seems to imply that any change in the creditworthiness of the parties to the derivative must be taken into account for purposes of the assessment of effectiveness, while paragraph 124 implies that for purposes of the measurement of ineffectiveness, there would be no recorded ineffectiveness related to changes in credit risk of the parties to the derivative instrument in a cash flow hedge. Currently, ASC paragraph 815-25-35-3 states that the methods used to assess effectiveness and measure ineffectiveness should be consistent; therefore we would like to understand if the proposal is intended to be a change to that general concept.

Transition

In addition to our previous discussion of transition related to hedging relationships for which an entity had assumed perfect effectiveness, we believe that the FASB should provide specific transition guidance related to hedging relationships that would be impacted by the proposed changes (such as the lowering of the effectiveness threshold from highly effective to reasonably effective). The proposal is unclear if entities would be required to dedesignate existing hedging relationships that would be impacted by the proposed changes and redesignate new hedging relationships, or if entities would be able to continue hedging relationships that were entered into prior to the proposal becoming effective. In addition, if entities would be permitted to continue existing hedging relationships, we believe that the proposal should clarify if associated hedge documentation would require updating.

Disclosures

Allowance for Credit Losses¹⁷

Paragraph 104(a) of the proposal would require entities to disclose the activity within the allowance for credit losses during the period, separately for financial assets assessed for impairment individually and on a pool basis. ASU 2010-20 requires a similar disclosure for financing receivables; however in that disclosure there is no requirement to present separately the activity within the allowance for credit losses by impairment

.

¹⁷ Ouestion 65



methodology.¹⁸ We believe that separately presenting activity based on the method for determining impairment may not be operational, because the method of assessing impairment for a given financial asset may change from period to period. We do not believe the benefit from this granular level of disclosure outweighs the cost of preparing the disclosure.

In addition, the proposal would require separate disclosure of changes in the allowance for credit losses due to changes in methodologies and estimates. We support disclosure of the effect on the allowance due to changes in methodologies. However, by necessity the change in the allowance for credit losses is the result of numerous estimates affecting the cash flows expected to be collected, and thus the change in the allowance for credit losses due to changes in estimates is inseparable from changes due to changes in expected cash flows. The FASB should remove the requirement to disclose the effect of changes in estimates.

Effective Date¹⁹

In general, we support the proposed delayed effective date for classification and measurement guidance related to loans, loan commitments, and core deposit liabilities for nonpublic entities with less than \$1 billion in consolidated assets. However, we believe that the evaluation of whether an entity qualifies for the four-year delay should be completed only once at initial adoption of the proposal. We do not believe entities should be required to reevaluate this criterion on a continuous basis. Given the significant accounting and reporting changes that would be required upon the full adoption of the proposal, it would be very difficult for an entity that met the criterion in the first year of application to be required to immediately apply the delayed guidance if its recognized assets are greater than \$1 billion in a future period.

We believe that a one-time evaluation of an entity's consolidated assets at the initial adoption of the proposal should be sufficient if the FASB's main reason for providing a delay in the effective date for certain nonpublic entities is due to concerns about the amount of time necessary for these entities to obtain the appropriate resources and facilitate systems changes.

¹⁹ Question 69

¹⁸ FASB Accounting Standards Update No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*



The following are minor editorial comments that the FASB should consider to enhance the clarity of the proposal.

- Paragraph 12(c) should include the following language included in paragraph 12(b): "See paragraphs 14-17 for a discussion of situations in which an entity has reason to expect that the fair value of such a financial instrument may differ significantly from the transaction price."
- Paragraph 20 states that an entity shall report in net income all changes in the fair
 values of equity instruments held (with the exception of investments in equity
 securities that are accounted for using the equity method of accounting as described in
 Topic 323 or that result in the consolidation of an entity). Investments in equity
 securities measured at their redemption amounts should also be included in the list of
 exceptions.
- Paragraph 53 contains a general statement that an entity shall recognize any
 unfavorable change in cash flows expected to be collected as a credit impairment. We
 suggest that this language be qualified, because the proposed guidance for financial
 assets purchased at an amount that includes a discount related to credit quality would
 allow for decreases in expected cash flows to reduce the effective interest rate, when
 the effective interest rate had previously been increased subsequent to acquisition.
- Paragraph 76 states that entities shall include in net income an amount of interest income related to financial assets measured at fair value with qualifying changes in fair value recognized in OCI. We do not believe the FASB intends this statement to preclude interest income recognition on financial assets measured at fair value with changes in fair value recognized in net income. Our understanding is based in part on the example in paragraph IG95 which illustrates the accounting for a loan measured at fair value with changes in fair value recognized in net income. We suggest the FASB clearly state that for those financial assets interest income recognition guidance in current GAAP would not change.
- Paragraph 92 states that "As a consequence, the entity shall not present separately a transaction gain or loss in net income as otherwise would be required by Topic 830."
 We believe that this sentence should be modified to clarify that a transaction gain or loss would not always be recognized in net income because certain financial instruments may be part of a foreign currency transaction that qualifies for gains and losses to be recorded in OCI under FASB ASC paragraph 830-20-35-3.
- Paragraph 104(a) would require disclosure of the activity in the allowance for credit losses during the period. The proposal states that the activity to be disclosed would include additions charged to net income and amounts due to any changes in methods or estimates. We believe in most instances changes in methods or estimates would already be reflected in additions charged to net income.
- The last sentence of paragraph IG22 contains an abbreviated description of a core deposit liability that excludes the requirements that the deposits do not have a



contractual maturity and that the deposits are considered to be stable sources of funding. This sentence should be revised to be consistent with the Master Glossary definition.