Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of the Comptroller of the Currency
Office of Thrift Supervision

September 30, 2010

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

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

Dear Mr. Golden:

As principals of the five federal financial institution regulatory agencies ("the Agencies"), we collectively have responsibility for overseeing the safety and soundness of over 15,000 U.S. financial institutions. As the nation emerges from the recent financial crisis, we are evaluating all appropriate steps to ensure that the United States does not experience a similar episode going forward. In light of our responsibility and recent Congressional mandates, we have reviewed your proposal and considered the effect it would likely have on the financial sector. We are concerned about the potential implications of the proposal for financial intermediation and stability and, therefore, we oppose the proposed requirement to report substantially all of a financial institution's financial instruments at fair value (or another "current value") on the balance sheet.

In our view, the accounting for financial instruments should reflect a financial institution's business strategy and the manner in which cash flows will be realized or expended. Although fair value accounting is appropriate for trading activities and derivative instruments, it is generally not appropriate for financial instruments held for collection or payment purposes. Measurement at amortized cost, together with an improved impairment model, is more relevant and decision useful for instruments such as loans, core deposits, and other non-derivative financial liabilities. We support improved footnote disclosure of fair value information as a supplement to these balance sheet measures.

We also support a credit impairment model that is more forward looking and provides for earlier recognition of losses than the current incurred loss approach. We agree that impairment should be recognized for cash flows that management does not expect to collect. In measuring

impairment, management is required to use judgment and should consider all reasonable and supportable information, including forecasts of future conditions. Accordingly, we cannot support the proposed aspects of the impairment model that would impose artificial constraints on management that they would not place on their own assessment of credit impairment, such as the "freezing" of current economic conditions. Such constraints also would be inconsistent with the views of the G20 leaders and the Financial Stability Board on strengthening impairment accounting by incorporating a broader range of credit information.

Observations from the Recent Crisis

During the financial crisis, fair values for many financial instruments diverged significantly from expected collections of future cash flows. The lack of market confidence in fair value estimates undermined financial stability and fostered pro-cyclical economic effects as fair value "marks" spiraled downward. The same could be said of overly optimistic fair value measurements prior to the crisis, which were a byproduct of short-term risk taking and market exuberance. This illustrates the shortcomings of extending the use of fair value to measure financial results of financial institutions whose business strategies are not predicated on the sale of financial instruments.

Additionally, before the crisis, there were clear indications of increased credit risk in loan portfolios, with no commensurate increase in loan loss allowances. We believe that a move to an expected loss model will result in the earlier recognition of expected credit losses and would be an improvement over the current incurred loss approach.

We agree with the sentiment expressed by the Financial Crisis Advisory Group and others that weaknesses in accounting standards reduced the credibility of financial reporting during the crisis and that a simplified mixed attribute model for financial instruments would be preferable to a full fair value-based model. Thus, we urge the Board to develop a framework for financial instruments that is consistent with an institution's business strategy.

Costs and Benefits

A variety of financial institution stakeholders have indicated that the proposal would create a significant operational and cost burden, particularly for smaller institutions, with no appreciable benefit for users of their financial statements. Many of these smaller institutions do not issue financial statements, but the balance sheets and income statements in the regulatory reports they file would have to be prepared in accordance with the proposal if it were to be adopted. As prudential supervisors who oversee the safety and soundness of financial institutions, we do not believe the cost-benefit test is satisfied when the increase in cost is not commensurate with the benefit that would be derived based on how the institution is managed and analyzed.

Convergence

Finally, the proposal is significantly different from the financial instruments accounting standard issued by the International Accounting Standards Board. Achieving high quality, converged accounting standards for financial instruments is critical for the efficient functioning of global

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financial markets. Divergence in this area would provide incentives for the inefficient allocation of credit and would undoubtedly result in inappropriate arbitrage opportunities. Thus, we urge both boards to work together to achieve a converged standard for financial instruments.

Other Comments

Our staffs have analyzed your proposal and have prepared the attached comments on specific aspects of the proposal as well as responses to certain questions. Please contact the Agencies' Chief Accountants if you wish to discuss these comments further.

Sincerely,

Ben S. Bernanke Chairman of the Board Board of Governors of the Federal Reserve System Sheila C. Bair Chairman Federal Deposit Insurance Corporation

Debbie Matz Chairman of the Board National Credit Union Administration John Walsh Acting Comptroller Office of the Comptroller of the Currency

John E. Bowman Acting Director Office of Thrift Supervision

Attachment

Interagency Staff Comments on the Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

General Comments

Presented below are the general comments of the staffs of the five federal financial institution regulatory agencies (Agencies)¹ on each of the topic areas in the Financial Accounting Standards Board's (FASB or Board) proposed standard on accounting for financial instruments and certain related issues, followed by more specific responses to selected questions included in the proposal. Our views in these areas benefited from discussions with investors, preparers, practitioners, and others in the financial services arena. We have also considered the International Accounting Standards Board's (IASB) final and proposed guidance for financial instruments. Where applicable, we have commented on the relative merits of the FASB's and IASB's (collectively, the Boards) approaches.

The Agencies supervise more than 15,000 financial institutions. Summary statistics for these institutions include:

- > Approximately 7,700 credit unions
 - More than 97 percent of credit unions have less than \$1 billion in assets (more than 95 percent of credit unions have less than \$500 million in assets)
 - All of the credit unions are mutual institutions
- Approximately 6,700 commercial banks and 1,100 savings institutions (collectively, banks)
 - More than 91 percent of banks have less than \$1 billion in assets (more than 82 percent of banks have less than \$500 million in assets)
 - Approximately 6,000 of the 7,800 banks are owned by nearly 5,300 holding companies, of which 15 percent are public companies
 - Of the approximately 1,800 banks not owned by holding companies, 5 percent are public companies
 - Approximately 2,400 of the 7,800 banks are S corporations that have (or whose parent holding companies have) no more than 100 shareholders
 - Approximately 500 of the savings institutions are mutual institutions

These statistics show that the vast majority of the institutions that we supervise are nonpublic entities with less than \$1 billion in total assets. The proposal defers certain measurement provisions for these institutions. In this regard, we agree with the alternative view expressed by Ms. Seidman and Mr. Smith that the proposed deferral for these entities raises significant

¹ The Agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

questions about the operationality of the proposed standard and whether the improvements in financial reporting and intended benefits would be achieved in a timely fashion, if at all. While we share their concerns, we have strong objections to significant portions of the proposal as it would apply to all entities, not just those to which the deferral would apply.

Convergence

The Agencies have long supported the convergence of U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) with the goal of achieving a single set of high-quality accounting standards. The FASB's comprehensive proposal on accounting for financial instruments is part of a major project in the Memorandum of Understanding issued in 2006 and updated in 2008 by the FASB and the IASB. In a November 2009 joint statement, the two Boards reaffirmed their commitment to improve U.S. GAAP and IFRS and to achieve convergence.

We recognize that a number of factors have complicated the Boards' convergence efforts for financial instruments accounting, resulting not only in differing project approaches and timelines, but also differing decisions on a number of important aspects of their proposed standards. We are concerned that, notwithstanding the standard setters' commitment to convergence, the issuance of fundamentally different proposals creates uncertainty and confusion among preparers and users. We believe that the FASB and the IASB should work in a more coordinated fashion to issue harmonized proposals for global consideration. A coordinated process would be more consistent with the goal of convergence and enable interested parties to review and comment on proposals in a more efficient and effective manner.

Given the significant differences in direction that the FASB and the IASB have taken for financial instruments, it is imperative that the two Boards work more closely toward consensus and improving financial reporting. Reaching a converged, high-quality standard on financial instruments would be consistent with the objective established for accounting standard setters by the G20 leaders in April 2009.

Initial and Subsequent Measurement

The Agencies oppose the proposed requirement to report substantially all of an entity's financial instruments at fair value (or another "current value") on the balance sheet. We believe the proposal would result in a less faithful representation of a financial institution's business. The Agencies support two primary measurement categories for financial instruments: (1) amortized cost, subject to a robust asset impairment model, and (2) fair value with changes in value recognized in net income (FV-NI). The determination of the category in which a financial instrument would fall would be based on an entity's business strategy and the cash flow characteristics of the financial instrument. Under this two-category approach, derivatives and trading activities would continue to be measured at FV-NI. An exception to this approach would be needed to address fair value changes attributable to changes in an entity's own credit risk when the fair value option is elected for financial liabilities. We recommend that these fair value changes be reflected in other comprehensive income (OCI) rather than in net income. Our recommended two-category approach would simplify the accounting for financial instruments

and would more fully reflect the financial performance of the entity, which is further discussed below. It would also represent an important step toward achieving a high-quality, converged accounting standard for financial instruments.

The FASB's proposal would significantly expand the required use of fair value and would result in financial institutions reporting nearly all of their assets on that basis. We firmly believe that financial statements should use a measurement framework that reflects an entity's business strategy. Fair value measurement may be appropriate for an institution employing a business strategy that seeks to profit from short-term price movements. However, the primary business strategy for the vast majority of financial institutions that we supervise is a long-term strategy for financial intermediation that is based on maturity transformation. This largely involves funding long-term loans with deposits backed by deposit insurance protection, and earning an interest margin on the difference between the interest income generated and the associated funding costs. Fair value measurement would not faithfully reflect these institutions' financial position because their business strategies are not predicated on the sale or transfer of these instruments, but rather the collection and payment of contractual cash flows. We believe the FASB's concept of "collection or payment of contractual cash flows" is narrower than the subset of the activities that bankers, analysts, and supervisors often view as traditional banking and credit union activities. Consequently, while we use the FASB's "collection or payment" terminology in these comments, we do not necessarily agree with the constrained activities to which the FASB envisions it applies.

Amortized cost is generally a more representative measurement for financial instruments held for collection or payment purposes because it best reflects the expected receipt or payment of future cash flows. This would include loans, core deposits, and an entity's own debt. Consideration must also be given to the variability of expected cash flows. Thus, we support classification criteria that are based on both an entity's business strategy and the cash flow characteristics of a financial instrument. For this purpose, we support the following:

<u>Business strategy</u>. We favor the IASB's approach for the business strategy criterion, including reclassification when a business strategy changes and a more qualitative approach for assessing sales from a held-for-collection portfolio that would not call into question an entity's business strategy ("permissible sales"). To promote transparency, an entity should disclose its reasons for reclassifying financial instruments and the associated impact on its financial statements. We further recommend that an entity disclose the activity in its held-for-collection portfolios related to permissible sales (e.g., turnover ratios) and that the FASB include guidance with respect to sales in response to asset-liability management activities.

<u>Cash flow characteristics</u>. We generally favor the FASB's approach for the cash flow characteristic criterion because we believe that it is clearer and more direct than the IASB's approach. In order to reflect the variability of expected cash flows for derivatives, certain hybrid financial assets, and equity investments, we agree that these instruments should be measured at FV-NI because this measurement basis better reflects their risk characteristics and the manner in which cash flows will be realized.

The classification and measurement provisions of the proposed standard do not meet the FASB's objective of providing an improved and consistent financial reporting model for financial instruments, nor do they increase the usefulness of information reported in the financial statements for the broad range of users. In conducting our information-gathering activities, the predominant view among investors and bank analysts was that the use of fair value as the primary measurement method would obfuscate the information they need to evaluate the performance of financial institutions. This same unfavorable outcome would apply to other users of financial statements such as creditors (which include other financial institutions) and prudential regulators.

For example, investors and creditors tell us that they want information with which they can better evaluate an institution's actual and projected cash flows. Financial measures that help assess cash flow prospects would be more relevant to these users than fair value. These users would need to recast the financial statements to meet their information needs if the proposal were adopted. However, under the proposal, they may not be able to fully reconstruct the information presented in the financial statements in a manner that is consistent with their needs due to the loss of amortized cost information (e.g., for instruments that would be measured at FV-NI).

Presenting fair value estimates in the primary financial statements for illiquid instruments such as loans may create a false sense of precision or raise significant questions among users regarding these inherently subjective estimates. This would be particularly troublesome for financial institutions engaged in traditional lending activities for which loans often constitute more than two-thirds of total assets. During periods of market dislocation or periods of economic expansion, estimates of fair value for loans can fluctuate widely based on the perceptions and risk aversion of market participants. These fair value estimates could result in business or investment decisions based on false signals or result in overreactions to short-term market movements. For these reasons, we believe the required use of fair value as the primary measure for nearly all financial instruments would reduce the quality and undermine the efficacy of the primary financial statements for the broad range of financial statement users.

Accordingly, we generally do not support the use of fair value as the balance sheet measure for financial instruments held for collection or payment purposes. Measuring these instruments at fair value on the balance sheet would misrepresent an entity's financial position and performance measures, including comprehensive income. Rather than measuring these instruments at fair value on the face of the balance sheet, we support an improved impairment model and enhanced supplemental disclosure of fair value information to meet the needs of the broad range of financial statement users. This could include more granular disclosure of fair value information by class of financial instrument, supported by key assumptions and methodologies.

We believe supplemental fair value disclosures could be enhanced if the FASB were to make the disclosure requirements in Accounting Standard Codification (ASC) Topic 825, *Financial Instruments*, more consistent with ASC Topic 820, *Fair Value Measurements and Disclosure*. We further note that some Board members have stated that an objective of the fair value measurement provisions in the proposal is to provide investors with fair value information earlier in the cycle of quarterly financial reporting. We encourage the FASB to closely collaborate with the Securities and Exchange Commission to identify what disclosure would be most informative

to public company investors and the best avenues for such entities to deliver that information to investors. In addition, we understand that some analysts have suggested that they have a stronger interest in obtaining better disclosures about an entity's interest rate risk profile than in moving to fair value measurement for substantially all financial instruments. The Agencies would support further effort by the FASB to evaluate this aspect of disclosure.

Measurement of Financial Liabilities

We believe that fair value measurement generally is inappropriate for financial liabilities because these instruments are typically settled with the counterparty rather than transferred to a market participant. Amortized cost is the appropriate measurement for most financial liabilities, including core deposits. A depositor would not settle its account for less than the contractual amount due, particularly when the deposit is backed by deposit insurance. As such, we oppose the proposed remeasurement approach for core deposit liabilities. However, we would support enhanced disclosure of information about the significant attributes of core deposits (e.g., deposit run-off expectations).

Although we generally oppose fair value measurement for financial liabilities, fair value is appropriate for trading activities and derivatives and may be applicable in limited instances when the fair value option is elected (e.g., to mitigate an accounting mismatch that exists between an asset and its funding source). The Agencies continue to oppose including changes in fair value attributable to changes in an entity's own creditworthiness in reported earnings, as stated in our April 2006 comment letter on the fair value option proposal (FASB File Reference 1250-001).

As seen during the recent financial crisis, some entities with deteriorating financial condition recorded significant increases in earnings from liabilities measured at fair value, which distorted reported equity amounts. We continue to oppose the counterintuitive recognition in earnings of unrealized gains and losses resulting from decreases and increases, respectively, in an entity's own credit risk for financial liabilities measured at fair value. As a practical solution for this issue, we believe reporting in OCI fair value changes attributable to changes in an entity's own credit risk for a liability carried at fair value pursuant to the fair value option is preferable to reporting such amounts in earnings. Such an approach is consistent with the IASB's proposal for the measurement of liabilities and would, therefore, help achieve convergence on this issue.

Credit Impairment

We support a credit impairment model that is more forward looking and results in earlier identification and recognition of credit losses (i.e., a more economic measure of credit deterioration) than the current incurred loss model. Earlier identification of credit losses is consistent with both providing transparency about changes in credit trends to financial statement users and achieving regulators' prudential objectives of safety and soundness. While the proposed removal of the probable threshold is a necessary improvement over the current impairment model, we believe that the proposed model needs further changes.

We believe the restrictive language in paragraphs 36 and 42 of the proposal, which specifies that an entity should assume that the economic conditions existing at the end of the reporting period

would remain unchanged for the remaining life of a financial asset(s) and that it should not forecast future events or economic conditions that did not exist at the reporting date, should be removed from the proposal. If the objective of the proposed credit impairment model is to estimate cash flows not expected to be collected (an expected loss approach), then an entity should consider reasonable and supportable forward-looking information when developing its loss expectations. Many of the factors listed in paragraph 43 incorporate forward-looking information, such as expectations of default, changes by rating agencies, and general economic trends. A consequence of the proposed limitation might be allowance levels that do not represent management's expectations of credit losses and, potentially, delayed recognition of credit losses when compared to the current incurred loss model.

We believe that an entity should record an impairment based on its best estimate of cash flows not expected to be collected over the remaining life of the asset (or pools of similar financial assets, either of which we later refer to as "asset") and that its estimate should incorporate reasonable and properly supported assumptions and judgments. The proposal should not place artificial restrictions on an entity's ability to form its best estimate of expected credit losses. In addition, impairment should be recognized immediately in net income and not deferred and amortized over time. This would result in more timely recognition of credit losses, consistent with the recommendations of the G20 leaders and the Financial Stability Board. To promote comparability, we support comprehensive and informative disclosures describing an entity's process for and inputs used in estimating credit losses.

We strongly urge the FASB to work closely with the IASB to develop a single, converged impairment model applicable to both originated and purchased financial assets. In this regard, the Boards should also consider the work of the Expert Advisory Panel (EAP). It is crucial that the Boards operate on the same timeline for redeliberations. The overall objective for this collaboration should be a single model that is operational for entities of all sizes and makes use of processes and systems already in place.

Interest Income Recognition

We agree that an entity should not recognize interest income that is not expected to be collected. However, we believe that the current interest recognition model, together with an improved credit impairment model and a nonaccrual principle more in line with current practice, would be sufficient to address the need for improvement to the interest income recognition model. Accordingly, we oppose the proposed recognition of interest income on the basis of a financial asset's amortized cost balance net of any allowance for credit losses.

Coupling the effects of credit impairment with the recognition of interest income would reduce financial statement transparency. Such a requirement would create unnecessary work to reconstruct gross balances and related cash flows from net interest income in order to arrive at commonly used information for financial analysis.

In addition, the proposal potentially permits inappropriate interest income recognition in certain circumstances. For example, it could result in a situation where interest income is recognized on

a loan that is not performing according to its contractual terms but where any shortfall is expected to be recovered from the underlying collateral rather than from cash payments.

In place of the proposed interest income approach, we recommend that a final standard include a general nonaccrual principle stating that the accrual of interest income should cease on a financial asset when full payment of principal and interest in cash is not expected. This principle would apply equally to investments and originated loans for which contractual cash flows are not expected and to purchased financial assets for which there are reductions in the amount of initially expected cash flows.

The proposed interest income recognition model also presents numerous operational challenges for financial institutions. It would require significant system and process changes, including the integration of loan accounting systems with credit systems to determine the amount of interest accrual. This would be a costly and complex exercise because financial institutions typically manage interest rate risk and credit risk separately. Allocating general or portfolio-level credit loss estimates to individual loans in order to measure interest income for financial reporting purposes raises additional operational concerns.

We do not believe the benefits of the proposed interest income recognition model outweigh the cost. The current interest recognition model, including the nonaccrual concept applied by financial institutions, is well understood by preparers and users, and we are not aware of any calls from users for a change in this area. We believe that the FASB's objectives and efforts would be better served by improving the credit impairment model.

Hedging Activities

The Agencies strongly support the Board's retention of the concept of risk selection that underlies current standards on hedge accounting. As prudential supervisors, we expect financial institutions to engage in sound risk management practices for exposures such as interest rate risk. Derivatives can be an important tool for managing risk. To that end, we support the Board's efforts to simplify hedge accounting requirements by moving from the current, purely quantitative hedging guidance toward a more qualitative approach for assessing hedge effectiveness. We further support the proposed elimination of the shortcut and critical-termsmatch methods, thereby removing the accounting presumption of no hedge ineffectiveness.

However, in order to maintain rigor when introducing a more qualitative approach to hedge effectiveness, we encourage the FASB to provide additional guidance on the types of qualitative judgments that are consistent with the Board's intent. Furthermore, since a decision to terminate hedge accounting is based in part on an institution's predictions about the hedging relationship performance (i.e., it is no longer expected to be effective), we believe further guidance is needed for evaluating when the qualifying hedging criteria are no longer met and hedge accounting should be terminated. To promote transparency in this area, we also encourage the Board to develop disclosure requirements that will provide users insight into the qualitative factors that an entity relied upon to demonstrate that its hedging relationships are reasonably effective.

Given the fact that the IASB has not yet issued its proposal on hedge accounting, our comments on the merits of the FASB's proposed hedging guidance should not be considered final. We believe there may be significant differences between the two Boards' proposals. Consequently, diligent work by the FASB and the IASB to achieve convergence is highly desirable.

Costs versus Benefits

Many smaller credit unions and nonpublic banks and holding companies do not issue full financial statements prepared in accordance with GAAP (e.g., no footnote disclosures or statements of cash flows); however, all of these entities must submit regulatory reports (e.g., report of condition, report of income, and supplemental schedules) to the Agencies prepared in accordance with GAAP. In this regard, Section 37 of the Federal Deposit Insurance Act requires accounting principles applicable to regulatory reports filed with the federal banking agencies to be uniform and consistent with GAAP. If the appropriate federal banking agency or the Federal Deposit Insurance Corporation (FDIC) determines that the application of any generally accepted accounting principle to an FDIC-insured institution is inconsistent with specified safety and soundness objectives set forth in Section 37, the agency or the FDIC may prescribe an accounting principle applicable to such institution, provided it is no less stringent than GAAP. The Federal Credit Union Act contains statutory language comparable to Section 37 of the Federal Deposit Insurance Act, but applicable to federally insured credit unions. As a consequence, the FASB's proposed financial instruments accounting standard would apply to the balance sheets and income statements that all financial institutions supervised by the agencies prepare for regulatory reporting purposes, even if they do not otherwise issue a full set of financial statements.

Implementing the proposed standard would impose significant costs on all supervised institutions; however, these costs would likely be borne disproportionately by small institutions, both public and nonpublic. In particular, none of the bankers from small institutions with whom we spoke about the proposal use fair value estimates in managing their businesses, nor have those with a stock form of ownership found that investors in their organizations expressed a desire for receiving financial reports in which fair value is used as the primary measurement attribute for financial instruments. Since there are no investors per se in credit unions and mutual savings institutions, we are unable to determine who would benefit from these organizations preparing fair value-based balance sheets.

Moreover, virtually all of these institutions would need to turn to outside service providers to generate the fair value estimates (and core deposit remeasurements) necessary to implement the proposed standard. This is already the case for the fair values of investment securities these institutions report in their regulatory reports under current accounting standards. We do not believe that the FASB has sufficiently and properly considered this cost aspect of the proposal in its cost-benefit analysis for small companies, whether they are public or nonpublic. The four-year deferral for certain aspects of the proposal that has been proposed for small private companies does little to balance the cost-benefit equation.

Furthermore, even for the largest public institutions supervised by the Agencies, the cost of implementing the proposed standard would likely be substantial. Our opposition to many key aspects of the proposal, as discussed above, and the questionable benefits that they would provide to financial statement users leads us to conclude that the benefits of the proposal to the broad range of financial statement users do not outweigh the costs across the full range of financial institutions. As it redeliberates the proposal, the FASB needs to carefully reevaluate both costs and benefits and develop an accounting model for financial instruments that fits all institutions in a cost-effective manner and provides relevant, decision-useful information through a balance of financial statement measurement and recognition principles and supplemental disclosures.

Contact Information

The preceding general comments and the responses to selected questions in the Appendix have been prepared by the staffs of the Agencies. If you have any questions regarding our comments, please feel free to contact Arthur Lindo at the Board of Governors of the Federal Reserve System, Robert Storch at the Federal Deposit Insurance Corporation, Karen Kelbly at the National Credit Union Administration, Kathy Murphy at the Office of the Comptroller of the Currency, or Jeffrey Geer at the Office of Thrift Supervision.

Responses to selected questions

Question 1

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

We believe that there are conceptual advantages to a comprehensive accounting framework for all financial instruments with limited exceptions. The current piecemeal approach to accounting for financial instruments has led to gaps and inconsistencies in accounting standards. Developing a new approach that applies across most financial instruments would reduce the complexity of accounting standards as well as improve transparency and consistency. Due to the differences in timing between various FASB projects, it is understandable that certain financial instruments would currently be excluded from the scope of this proposal. Ultimately, however, we would expect that the scope would be expanded, as appropriate. For example, we would expect the allowance for lease losses to be aligned with a final credit impairment model for financial instruments.

Question 2

The proposed guidance would require loan commitments, other than loan commitments related to a revolving line of credit issued under a credit card arrangement, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

As noted in our response to Question 1, we support having a comprehensive accounting framework for financial instruments. However, given our strong support for an accounting model that reflects an entity's business strategy and our opposition to the required use of fair value for most lending activities, we agree that it would be appropriate to exclude loan commitments related to a revolving line of credit issued under a credit card arrangement. More fundamentally, we object to the proposed expansion of fair value accounting to other loan commitments (other than those that relate to the origination of mortgage loans that will be held for sale, which currently are treated as derivatives and measured at fair value).

Ouestion 8

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

We agree that initial measurement at fair value would be appropriate for instruments such as trading securities, derivatives, certain hybrid financial assets, debt securities that can be contractually prepaid in such a way that an investor would not recover substantially all of its initial investment (other than through its own choice), and most equity securities.² This may result in a "day one" gain or loss to the extent that the fair value differs from the transaction price. For instruments held for collection or payment purposes, we support initial measurement at the transaction price, assuming that there are no other elements in the arrangement that warrant

² This outcome is consistent with classification criteria that are based on both an entity's business strategy and the variability of expected cash flows.

separate accounting. Measuring those instruments at the transaction price (and subsequently at amortized cost) best reflects the manner in which cash flows will be realized or expended.

Ouestion 9

For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

We believe that an entity's business strategy should be the primary consideration in determining the measurement attribute for financial instruments. Amortized cost is generally the most relevant measurement attribute for instruments held for collection or payment purposes. For such financial instruments, absent other elements in a transaction that warrant separate accounting, we do not support the recognition in net income (or OCI) of a difference between the transaction price and fair value on the transaction date for instruments held for those purposes. Such a result would be inconsistent with a business strategy of collecting or paying contractual cash flows over the life of an instrument.

Ouestion 10

Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?

No, while we support fair value for initial measurement of certain instruments such as those detailed in our response to Question 8, we generally do not support fair value as the initial measurement attribute for instruments held for collection or payment purposes.

Ouestion 11

Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

We agree that transaction fees and costs should be (1) expensed immediately for instruments measured at FV-NI and (2) deferred and amortized as an adjustment to yield for instruments held for collection or payment purposes. However, we do not support measuring the latter instruments at fair value with certain qualifying changes in fair value recognized in OCI (FV-OCI). We believe that amortized cost is generally the most relevant measurement attribute for these instruments.

Ouestion 13

Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

No, we do not support having fair value as the default measurement attribute for financial instruments. We believe that the measurement method should be determined on the basis of an entity's business strategy and the variability of expected cash flows. As such, loans and securities held for collection purposes would generally be measured at amortized cost. Additionally, we believe that fair value measurement for financial liabilities generally is inappropriate because these instruments are typically settled with the counterparty rather than transferred to a market participant. Amortized cost is the appropriate measurement for most financial liabilities, including core deposits and an entity's own debt. Please refer to our response to Question 15 for further information on our views related to the measurement of financial liabilities.

Question 14

The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?

No, as noted in our previous responses, we do not support measuring instruments held for collection or payment purposes at FV-OCI. We believe that amortized cost is generally the most relevant measurement attribute for these instruments.

Question 15

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

As noted previously, we generally support classification criteria that are based on both an entity's business strategy and a financial instrument's cash flow characteristics for determining the subsequent measurement of financial assets.

With respect to the business strategy criterion, we encourage the Board to consider the guidance in paragraph B4.3 of IFRS 9 *Financial Instruments* when determining the nature and extent of sales out of the held-for-collection category that would not call into question an entity's business strategy. That guidance would permit an entity to sell a financial asset to fund capital expenditures, to adjust its investment portfolio to reflect a change in expected duration, and to comply with its investment policy (e.g., when the credit quality of the asset declines below that required by policy). We believe the guidance should more clearly articulate the Board's intent with respect to permissible asset-liability management activities. To enhance transparency, we recommend that the FASB require an entity to disclose the activity in its held-for-collection portfolios related to permissible sales (e.g., turnover ratios).

We believe that fair value measurement for financial liabilities generally is inappropriate because these instruments are typically settled with the counterparty rather than transferred to a market participant. Amortized cost is the appropriate measurement for most financial liabilities, including core deposits. For financial liabilities measured at fair value pursuant to a fair value option, we believe that changes in fair value attributable to changes in an entity's own credit risk should be included in OCI. Such amounts are generally not realizable and are therefore not reflective of the economic consequences of management decisions. As seen during the recent financial crisis, recording in net income changes in fair value attributable to changes in own credit risk had the contrary effect of increasing an entity's net worth as its financial condition deteriorated.

Question 16

Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?

We believe that the measurement method should be determined, in large part, on the basis of an entity's business strategy. Accordingly, we believe that reclassification should be required when an entity's business strategy changes. Such an assessment would not be made on an instrument-by-instrument basis.

We note that the Board based its decision to prohibit reclassification principally to curtail earnings management. While we share concerns about earnings management, we would expect reclassifications to be rare and evidenced by significant and comprehensive actions taken by an entity's management with the approval of those charged with governance (e.g., the board of directors). We would expect that the entity's strategic decisions, risk management policies, and business practices would all be affected by such a change and would be fully documented. Detailed disclosures explaining the reclassification and its impact on the financial statements should be required.

Ouestion 17

The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

No, we oppose the proposed remeasurement approach for core deposit liabilities. We believe that amortized cost is the most appropriate measurement attribute for those instruments. It represents the amount of cash that an entity would deliver upon settlement of the obligation with the depositor, which is payable on demand. A depositor would not settle its account for less than the contractual amount due, particularly when the deposit is backed by deposit insurance. Rather than applying the proposed remeasurement approach to core deposits, we would support enhanced disclosure of information about the significant attributes of core deposits (e.g., deposit run-off expectations).

The proposed remeasurement approach combines elements of an intangible asset in the measurement basis of the core deposit liability. This outcome seems arbitrary and inconsistent given that other internally-generated intangible assets are not recognized separately, much less bifurcated and afforded partial recognition as a de facto contra-liability. We have significant concerns about the reliability of the remeasurement estimate. Given the significant amount of core deposit liabilities at many financial institutions, small changes in an entity's assumptions could result in dramatically different results.

Ouestion 18

Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?

We believe that such a financial liability should be measured at amortized cost. This is consistent with our view that financial liabilities held for payment purposes should generally be measured on that basis. Derivatives embedded in these instruments should continue to be evaluated for potential bifurcation and separate accounting if not clearly and closely related to the host contract.

Question 19

Do you believe that the correct financial instruments are captured by the criteria in the proposed guidance to qualify for measurement at the redemption amount for certain investments that can be redeemed only for a specified amount (such as an investment in the stock of the Federal Home Loan Bank or an investment in the Federal Reserve Bank)? If not, are there any financial instruments that should qualify but do not meet the criteria? Why?

We generally agree with including investments in the stock of Federal Home Loan Banks and Federal Reserve Banks within the scope of the proposed guidance to qualify for measurement at the redemption amount. However, we do not believe that the proposed impairment approach for debt instruments should apply to these equity instruments. As such, we believe that paragraph 37(c) should be eliminated. We support the current impairment guidance in the FASB codification for these instruments and recommend that the Board cross-reference that guidance in a final standard.

In addition, we believe that the deposits that credit unions hold in the National Credit Union Share Insurance Fund (NCUSIF) should continue to be accounted for in accordance with ASC paragraphs 942-325-25-3 and 942-325-35-4 as long as such amounts are fully refundable. These funds are on deposit with the NCUSIF for insurance purposes. They are not certificates and do not represent ownership interests. The deposits do not meet the criteria for subsequent measurement at redemption value because the deposits do not entitle credit unions to "engage in transactions or participate in activities with the issuing entity." Accordingly, we recommend that the NCUSIF deposit be explicitly scoped out of paragraphs 34 and 37(c) and the related reference in paragraph BC148 be removed.

Ouestion 22

Do you believe that the recognition of qualifying changes in fair value in other comprehensive income (measuring the effects of subsequent changes in interest rates on fair value as well as reflecting differences between management's and the market's expectations about credit impairments) will provide decision-useful information for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows? If yes, how will the information provided influence your analysis of an entity? If not, why?

As noted previously, we believe that amortized cost is generally the most relevant measurement attribute for instruments held for collection or payment purposes. Therefore, we do not support the proposal to report such instruments at FV-OCI.

Question 23

Do you believe that a default classification and measurement category should be provided for financial instruments that would otherwise meet the criteria for qualifying changes to be recognized in other comprehensive income? If not, why?

As noted in our response to Question 13, we do not support having fair value as the default measurement attribute for financial instruments. We believe that the measurement method should be determined, in large part, on the basis of an entity's business strategy. Instruments held for collection or payment purposes generally should be measured at amortized cost because that measurement basis best reflects the manner in which contractual cash flows will be realized or expended.

Question 24

The proposed guidance would provide amortized cost and fair value information on the face of the financial statements. The Board believes that this would increase the likelihood that both measures are available to users of public entity financial statements on a timely basis and that both measures are given equal attention by preparers and auditors. Do you believe that this approach will provide decision-useful information? If yes, how will the information provided be used in the analysis of an entity? If not, would you recommend another approach (for example, supplemental fair value financial statements in the notes to the financial statements or dual financial statements)?

No, we do not believe that this approach will provide the most decision-useful information. We believe that the face of the financial statements should reflect only the most relevant measurement attribute for a financial instrument. This should be determined, in large part, on the basis of an entity's business strategy. Consideration must also be given to the financial instrument's cash flow characteristics. Amortized cost is generally the most relevant measurement attribute for instruments such as loans and securities held for collection and core deposits and other financial liabilities held for payment purposes. Providing fair value information on the face of the financial statements for those instruments would obfuscate the measure that most closely aligns with how the instruments are managed and may also result in delayed reporting of financial results. As we noted in our general comments, presenting fair value estimates on the face of the financial statements for instruments such as loans may create a

false sense of precision. The same would be true of other instruments measured using significant unobservable inputs.

We support enhanced supplemental disclosure of fair value information. This could include more granular disclosure of fair value information by class of financial instrument, supported by key assumptions and methodologies. Supplemental fair value disclosures could be further enhanced if the FASB were to make the disclosure requirements in ASC Topic 825 more consistent with ASC Topic 820.

Ouestion 25

For hybrid financial instruments that currently would require bifurcation and separate accounting under Subtopic 815-15, do you agree that recognizing the entire change in fair value in net income results in more decision-useful information than requiring the embedded derivative to be bifurcated and accounted for separately from the host contract? If yes, how will the information be used in the analysis of an entity? If not, for which types of hybrid financial instruments do you believe that it is more decision useful to account for the embedded derivative separately from the host contract? Why?

We generally support classification criteria that are based on both an entity's business strategy and an instrument's cash flow characteristics for determining which financial assets should be subsequently measured at amortized cost. This would include hybrid financial assets. For hybrid financial assets that do not satisfy these criteria and are therefore subsequently measured at FV-NI, we recommend that the FASB require an entity to disclose amortized cost information for the "host" financial assets to provide additional information to the broad range of financial statement users about the underlying cash flows of the host instrument.

We believe that amortized cost is the most relevant measurement attribute for most financial liabilities because those instruments are typically settled with the counterparty according to their contractual terms rather than transferred to a market participant. For that reason, we support bifurcation and separate reporting for derivatives embedded in a host financial liability.

Question 26

Do you believe that the proposed guidance for hybrid financial instruments or the IASB's model for accounting for financial hybrid contracts will provide more decision-useful information? Why?

As noted in our response to Question 25, we generally support classification criteria that are based on both an entity's business strategy and an instrument's cash flow characteristics for determining which hybrid financial assets should be subsequently measured at amortized cost. For hybrid financial liabilities, we support bifurcation and separate reporting for derivatives embedded in a host financial liability, consistent with the IASB's proposed approach. We believe that such an approach is more decision useful because it preserves amortized cost information for the "host" financial liability, which is generally not settled or transferred prior to maturity.

Ouestions 33 and 34

Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in the entity's credit standing (excluding the changes in the price of credit). What are the strengths and weaknesses of each method? Would it be appropriate to use either method as long as it was done consistently, or would it be better to use Method 2 for all entities given that some entities are not rated? Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity's credit standing, excluding the price of credit? If so, please explain why those methods would better measure that change.

The methods described in Appendix B for determining the change in fair value of a financial liability attributable to a change in an entity's credit standing (excluding the changes in the price of credit) assume that the entity would look to the cost of debt of other entities in its industry to estimate the change in credit standing, excluding the change in the price of credit. Is it appropriate to look to other entities within an entity's industry, or should some other index, such as all entities in the market of a similar size or all entities in the industry of a similar size, be used? If so, please explain why another index would better measure the change in the price of credit.

As noted in our general comments, we believe that fair value measurement for financial liabilities generally is inappropriate because these instruments are typically settled with the counterparty rather than transferred to a market participant. Amortized cost is the appropriate measurement for most financial liabilities. For financial liabilities measured at fair value pursuant to the fair value option, we believe that changes in fair value attributable to changes in an entity's own credit risk should be included in OCI. This would apply equally to changes in fair value attributable to a change in the entity's credit standing as well as changes in fair value attributable to the price of credit. Separating those elements would introduce needless complexity as neither element is generally realized. Rather than prescribing detailed guidance in this area, we recommend that the FASB require an entity to disclose its methodology for estimating changes in fair value attributable to changes in its own credit risk. This would be consistent with a principles-based approach.

Ouestion 37

Do you believe that the objective of the credit impairment model in this proposed Update is clear? If not, what objective would you propose and why?

Although the objective of the credit impairment model is stated in paragraph 38, we believe that certain aspects of the proposal contradict that objective and, therefore, cause it to be unclear. Specifically, paragraphs 36 and 42 could be viewed as undermining the objective of forming an expectation of credit losses by requiring an entity to assume that conditions existing at the measurement date will remain unchanged for the remaining life of a financial asset. In this regard, we understand the Board's intent in placing a boundary on the assumptions used in evaluating collectability and estimating credit losses. However, management should not be unduly constrained in considering forward-looking information that is reasonable and supportable when estimating credit losses. As such, we recommend that the Board remove the restrictive language in paragraph 36 and the last two sentences in paragraph 42.

Question 38

The proposed guidance would require an entity to recognize a credit impairment immediately in net income when the entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s). The IASB Exposure Draft, Financial Instruments: Amortised Cost and Impairment (Exposure Draft on impairment), would require an entity to forecast credit losses upon acquisition and allocate a portion of the initially expected credit losses to each reporting period as a reduction in interest income by using the effective interest rate method. Thus, initially expected credit losses would be recorded over the life of the financial asset as a reduction in interest income. If an entity revises its estimate of cash flows, the entity would adjust the carrying amount (amortized cost) of the financial asset and immediately recognize the amount of the adjustment in net income as an impairment gain or loss. Do you believe that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s) as proposed in this Update, or do you believe that an entity should recognize initially expected credit losses over the life of the financial instrument as a reduction in interest income, as proposed in the IASB Exposure Draft on impairment?

We believe that an entity should immediately recognize credit impairment in net income. In our view, the IASB's proposal to allocate initially expected credit losses over the life of a loan could result in deferred loss recognition. We communicated this view, along with supporting observations on the operational challenges presented by the IASB's proposal, in our comment letter to the IASB dated June 29, 2010.

Question 39

Do you agree that a credit impairment should not result from a decline in cash flows expected to be collected due to changes in foreign exchange rates, changes in expected prepayments, or changes in a variable interest rate? If not, why?

Changes in foreign exchange rates, expected prepayments, and variable interest rates are independent market factors that are not directly linked to the credit performance of a borrower. As such, we agree that declines in cash flows due to changes in these factors are not indicative of credit impairment.

Ouestion 40

For a financial asset evaluated in a pool, the proposed guidance does not specify a particular methodology to be applied by individual entities for determining historical loss rates. Should a specific method be prescribed for determining historical loss rates? If yes, what specific method would you recommend and why?

We do not support prescribing a single methodology for determining historical loss rates. Such methods currently range from simple to more complex techniques depending on the size of an institution and the nature, scope, and risk of its lending activities. At large institutions, loss rate methodologies often involve sophisticated models that require ongoing refinement by credit

specialists. Furthermore, determining loss rates requires the use of considerable judgment. Historical loss rates reflect an entity's product mix, underwriting policies and practices, and risk management activities, which also vary from institution to institution.

We believe that the FASB would be better served by clarifying what the allowance is supposed to represent. For example, it would be helpful if the Board outlined its intent regarding the time horizon for expected losses (i.e., whether the Board intends to have an entity use a weighted average life when determining the historical loss rate). We also recommend that the Board require an entity to disclose its methodology for determining historical loss rates.

Ouestion 41

Do you agree that if an entity subsequently expects to collect more cash flows than originally expected to be collected for a purchased financial asset, the entity should recognize no immediate gain in net income but should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset? If not, why?

Yes, the Agencies agree that when an entity subsequently expects to collect more cash than originally expected to be collected for a purchased financial asset that is being held for the collection of principal and interest, consistent with the entity's business strategy, the entity should recognize no immediate gain in net income. Rather, the entity should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset. This will match the realization of expected cash flows as they occur over time.

Question 42

If a financial asset that is evaluated for impairment on an individual basis has no indicators of being individually impaired, the proposed guidance would require an entity to determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit impairment exists. The amount of the credit impairment, if any, would be measured by applying the historical loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets to the individual financial asset. Do you agree with this requirement? If not, why?

Yes, we agree with this requirement. While there may not be signs of credit impairment on an individual basis, historical experience typically demonstrates that some loans within a group of loans with similar risk characteristics will not be repaid.

Question 43

The credit impairment model in this proposed Update would remove the probable threshold. Thus, an entity would no longer wait until a credit loss is probable to recognize a credit impairment. An entity would be required to recognize a credit impairment immediately in net income when an entity does not expect to collect all of the contractual cash flows (or, for purchased financial assets, the amount originally expected). This will result in credit impairments being recognized earlier than they are under existing U.S. GAAP. Do you believe

that removing the probable threshold so that credit impairments are recognized earlier provides more decision-useful information?

Yes, the Agencies believe that removing the probable threshold so that credit impairment is recognized earlier is an improvement over the current impairment model. Under the current accounting requirements, a provision for loan losses is recognized only when available information indicates that a loss impairment event has, or events have, occurred that are likely to result in nonpayment of a loan in the future. Identification of the loss event is a difficult and subjective process that results in a range of practice and, potentially, a failure to fully recognize existing credit losses early in the credit cycle. Earlier identification of credit losses is consistent with providing transparency into changes in credit trends to financial statement users and aiding to achieve regulators' prudential objectives of safety and soundness.

Question 44

The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectability of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on impairment proposes an expected loss approach and would require an entity to estimate credit losses on the basis of probability-weighted possible outcomes. Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would provide more decision-useful information?

The Agencies have analyzed both the FASB's and the IASB's impairment proposals. Our response to Question 38 notes that the IASB's proposal could result in deferred loss recognition, an outcome that would not improve financial reporting, and references our interagency comment letter to the IASB.

In determining whether a credit impairment exists, the Agencies do not agree with the FASB's proposal that an entity should assume that economic conditions existing at the reporting date would remain unchanged. We object to constraints that would artificially limit an entity's estimate of credit losses. Accordingly, we recommend that the FASB remove the restrictive language in paragraphs 36 and 42 that limits an entity's ability to consider forward-looking information when estimating credit losses.

We believe a final standard should include a clear principle stating the purpose of the credit impairment model for financial assets. The principle should require entities to consider all available information relating to past events, current conditions, and reasonable and supportable forward-looking information to estimate credit losses. Further, entities should document and disclose the relevant information that they considered in their evaluation of collectability and how it affected their estimate of credit losses. We believe that this would provide the most

decision-useful information to a broad range of financial statement users. It would also better align an entity's financial statements with its risk management practices.

Question 45

The proposed guidance would require that an appropriate historical loss rate (adjusted for existing economic factors and conditions) be determined for each individual pool of similar financial assets. Historical loss rates would reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool. Do you agree with that approach?

The Agencies generally agree with an approach that begins with a historical loss rate as an input; however, we do not agree with limiting adjustments of historical loss rates to existing factors and conditions. Estimates of credit impairment should consider reasonable and supportable forward-looking information. Some of the benefits of using a loss rate approach are that loss rates:

- Incorporate objective data already embedded in current credit functions and systems as a starting point for estimating credit impairment
- Can be developed and applied to pools of assets in open portfolios, which is consistent with the approach used by most financial institutions to manage credit risk (when supplemented by present value techniques for loans that are individually impaired)
- Are easily updated because the calculation is based on loan type, risk ratings, credit scores, or delinquency
- Are capable of being adjusted to reflect longer or shorter time horizons when appropriate
- Permit calculation of credit impairment without undue complexity

Question 48

The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Do you believe that the recognition of interest income should be affected by the recognition or reversal of credit impairments? If not, why?

No, we do not believe that credit impairments should affect the recognition of interest income in the manner proposed by the Board. The recognition of interest income should be separate from the recognition of credit impairment. We do not support the proposed interest income recognition model for the following reasons:

- Reduced transparency
- Significant operational challenges
- Permits inappropriate interest income recognition in certain circumstances
- Costs outweigh benefits
- Inconsistent with the goal of simplifying financial reporting

The proposal would reduce transparency and comparability among entities and across reporting periods. Financial statements currently present yield separate from credit risk for financial assets. Under the proposal, financial asset yields would be masked by combining the recognition of interest income with credit losses. As a result, users of financial statements would not be able

to readily determine what contractual yields on loans and other financial assets indicate about credit quality by subtracting the provision for loan losses from net interest margin.

As a further complication, the application and effect of recording the difference between interest contractually due and interest income accrued for a financial asset is not clear. If the difference increases the allowance for credit losses, as proposed, it appears to create ordering issues as interest income is calculated net of the allowance. It is also not clear whether an entity should calculate interest income based on the balance of the allowance at the beginning or the end of the period.

Traditional loan systems used as the basis for interest income accruals and credit risk systems supporting credit loss estimates are typically not integrated. Under the proposed guidance, entities would be forced to integrate these systems or resort to manual calculations to combine the recognition of credit impairment with interest income. This challenge is particularly acute because the allowance for loan losses for homogeneous loan pools is not allocated to individual loans. Solutions are likely to be complex and may increase the risk of reporting errors until effective internal controls over this new income recognition model can be designed and implemented.

The proposal potentially permits inappropriate interest income recognition in certain circumstances. The allowance for credit losses on collateral-dependent loans is typically based on the fair value of the collateral. Under the proposal, interest income would be recognized based on a loan's amortized cost less the allowance. Therefore, interest income for loans with excess collateral will continue to be accrued up to the fair value of the collateral, even when the lender does not expect to collect the interest in cash, but instead looks to the underlying collateral. Under current practice, the lender generally places the loan in nonaccrual status once full collection in accordance with the contractual terms is no longer expected.

We question whether the benefits of the proposed interest income recognition model outweigh the costs. Implementation of the proposal would require significant system changes and the resulting accounting would amount primarily to a change in geography on the income statement. The costs of complying with the proposal would be incremental to those incurred to maintain systems that track the legal amount of interest due for customer payment purposes and for legal needs in the event of bankruptcy or default. The current interest income recognition model is well understood and accepted by users of financial statements. Accordingly, we believe that the FASB's objectives would be better served if its efforts were focused on improving the credit impairment model.

Question 49

Do you agree that the difference in the amount of interest contractually due that exceeds interest accrued on the basis of an entity's current estimate of cash flows expected to be collected for financial assets should be recognized as an increase to the allowance for credit losses? If not, why?

No, if the allowance for credit losses equals an entity's estimate of cash flows that are not expected to be collected, then no additional adjustments to the allowance should be required.

Please refer to our response to Question 55 for further information related to the concept of nonaccrual assets.

Ouestion 50

The proposed guidance would permit, but would not require, separate presentation of interest income on the statement of comprehensive income for financial assets measured at fair value with all changes in fair value recognized in net income. If an entity chooses to present separately interest income for those financial assets, the proposed guidance does not specify a particular method for determining the amount of interest income to be recognized on the face of the statement of comprehensive income. Do you believe that the interest income recognition guidance should be the same for all financial assets?

Yes, regardless of whether financial assets are measured at FV-NI or amortized cost as we have recommended, interest income recognition guidance should be the same for all financial assets. This is particularly important for those financial assets that are held for collection purposes but are measured at FV-NI as a result of their cash flow characteristics.

Question 51

Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient to understand the proposed credit impairment and interest income models? If not, what additional guidance or examples are needed?

Although we do not agree with the proposed credit impairment and interest income recognition models, a comprehensive accounting framework for financial instruments would not be complete without implementation guidance and illustrative examples.

Question 52

Do you believe that the method for recognizing interest income on financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Recognizing interest income that is calculated by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses would not provide decision-useful information as it diminishes, not enhances, transparency.

Interest income and corresponding financial asset yields would mix interest and credit risk, which would make it difficult to differentiate fluctuations due to changes in the composite effective interest rate from those due to changes in credit impairment estimates. Comparability among entities and across reporting periods would also be significantly reduced.

In addition, as explained in our response to Question 48, the proposed method could result in inappropriate interest income recognition for collateral-dependent loans.

Question 53

The method of recognizing interest income will result in the allowance for credit impairments presented in the statement of financial position not equaling cumulative credit impairments recognized in net income because a portion of the allowance will reflect the excess of the amount of interest contractually due over interest income recognized. Do you believe that this is understandable and will provide decision-useful information? If yes, how will the information provided be used? If not, why?

No, we do not believe that this will provide decision-useful information for reasons previously noted.

Question 54

The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Thus, the recognition of a credit loss would result in a decrease in interest income recognized. Similarly, a reversal of a previously recognized credit loss would increase the amount of interest income recognized. The IASB Exposure Draft on Impairment proposes that an entity calculate interest by multiplying the effective rate established at initial recognition by the amortized cost basis. The IASB's definition of amortized cost basis is the present value of expected future cash flows discounted by the effective interest rate established at initial recognition and, therefore, includes credit losses recognized to date. Thus, as initially expected credit losses are allocated over the life of the instrument, the amount of interest income decreases. Both the FASB's and the IASB's models for interest income recognition are similar in that the recognition of an impairment reduces the amount of interest income recognized. However, as noted in the questions above, the timing of credit impairments and the determination of the effective interest rate differ in the two proposed models. Thus, the amount of interest income recognized under the two proposed models will differ. Do you believe that the FASB's model or the IASB's model provides more decision-useful information? Why?

In our view, neither the FASB's nor the IASB's model would provide more decision-useful information than the current interest income recognition model. We do not support mixing credit impairment and interest income recognition for the reasons previously stated. For a further discussion of our views regarding the IASB's model, please refer to our June 29, 2010 letter to the IASB.

Question 55

Do you agree that an entity should cease accruing interest on a financial asset measured at fair value with qualifying changes in fair value recognized in other comprehensive income if the entity's expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative? If not, why?

Yes, we agree that an entity should cease to accrue interest on a financial asset when its expectations are that the overall yield on the asset will be negative or zero. In addition, as noted in our response to Question 48, we are concerned that the proposed guidance could result in inappropriate interest income recognition for collateral-dependent loans.

Currently GAAP does not address the timing for ceasing accrual of interest income on financial assets. However, predominant practice for financial institutions is to follow nonaccrual guidance included in regulatory reporting instructions for all financial reporting. Therefore, we support including a general nonaccrual principle within GAAP, stating that the accrual and recognition of interest income on an investment or a loan should cease when full payment of principal and interest in cash is not expected. This principle would apply equally to originated financial assets for which contractual cash flows are not expected and to purchased financial assets for which there are reductions in the amount of initially expected cash flows.

Ouestion 56

Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

Yes, we support moving toward a more qualitative approach for assessing hedge effectiveness, recognizing that an entity would still be required to measure ineffectiveness and that this would necessitate a quantitative analysis for periods subsequent to hedge inception. To promote transparency in this area, we encourage the FASB to develop disclosure requirements that will provide insight into the qualitative factors that an entity relied upon to demonstrate that its hedging relationships are reasonably effective.

Question 57

Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?

No, we support maintaining an ongoing effectiveness evaluation, if even on a "change in circumstances" basis only. As a practical matter, we recognize that an entity would still be required to measure ineffectiveness and that this would necessitate a quantitative analysis for periods subsequent to hedge inception. The resulting ineffectiveness, if pronounced, would highlight any deteriorating hedging relationships.

Question 58

Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?

It is difficult to conclude whether a "trigger-based approach" for reassessment would result in a reduction of the number of discontinued hedging relationships. As a practical matter, an entity would still be required to measure ineffectiveness, and this would necessitate a quantitative analysis for periods subsequent to hedge inception. The resulting ineffectiveness would highlight any deteriorating hedging strategies.

Question 59

Do you believe that a hedge accounting model that recognizes in net income changes in the fair value and changes in the cash flows of the risk being hedged along with changes in fair value of the hedging instrument provides decision-useful information? If yes, how would that information be used? If not, why?

Yes, we believe that such a model would provide decision-useful information. The current hedge accounting model allows an entity to "under hedge" cash flow risks with no effect on earnings. The same is not true of fair value hedges. This inconsistent treatment between the two broad classes of accounting hedges potentially diminishes the quality of financial reporting. Having consistent models for fair value and cash flow hedges would bring more discipline to financial reporting.

Question 60

Do you believe that the proposed changes to the hedge accounting model will provide more transparent and consistent information about hedging activities? If yes, why and how would you use the information provided? If not, what changes do you disagree with and why?

Under the proposal, we believe that hedge accounting would be more consistent from period to period at an individual entity, but perhaps less comparable across entities, depending upon the range of qualitative factors on which each entity's hedge accounting rests. To promote transparency in this area, we encourage the FASB to develop disclosure requirements that will provide users insight into the qualitative factors that an entity relied upon to demonstrate that its hedging relationships are reasonably effective.