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Via electronic mail

Leslie F. Seidman, Chairman
Financial Accounting Standards Board
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PO Box 5116
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Mr. Hans Hoogervorst, Chairman
International Accounting Standards Board
30 Cannon Street, First Floor
London, EC4M 6XH
United Kingdom

Re: File Reference No. 2013-220: Proposed Accounting Standards Update, *Financial Instruments-Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Liabilities*

Exposure Draft ED/2012/4, *Classification and Measurement: Limited Amended to IFRS 9*

Dear Ms. Seidman and Mr. Hoogervorst:

Wells Fargo & Company (Wells Fargo) is a diversified financial services company with over \$1.4 trillion in assets providing banking, insurance, trust and investments, mortgage banking, investment banking, retail banking, and consumer finance services. We appreciate the opportunity to comment on the two exposure drafts, (1) Proposed Accounting Standards Update, *Financial Instruments-Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Liabilities* issued by the FASB and (2) Exposure Draft ED/2012/4, *Classification and Measurement: Limited Amended to IFRS 9* issued by the IASB (collectively, the "Proposed ASUs"). As the two proposals are largely the same, our comments apply to each except where otherwise noted.

Executive Summary

Wells Fargo supports the development of a classification and measurement framework for financial instruments that considers both the business model of an entity as well as the cash flow characteristics of a financial instrument. However, we are concerned that the proposed framework overemphasizes fair value measurement and significantly limits amortized cost measurement for many traditional and customary lending products held for the collection of contractual cash flows. As an example, we believe this limitation on the use of amortized cost measurement would apply to all loans that reset based upon the prime rate. We would like to remind the Boards that, in connection with the May 2010 exposure

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draft¹, the majority of financial statement users have expressed a preference for traditional performance measures coupled with existing supplemental fair value disclosures rather than the use of fair value as a primary measurement attribute.

The classification and measurement framework should be defined broadly enough to portray financial results that reflect the economic substance of lending and investing activities and associated risk management strategies of a financial institution. The framework should also help explain the impacts of management behavior rather than dictate management behavior or undermine risk management strategies. We do not believe the proposed framework will accomplish these objectives. The newly created SPPI test² too narrowly defines principal and interest and ascribes too much weight to inconsequential financial terms. The hold-to-collect business model too closely resembles the existing requirements for held-to-maturity classification of debt securities which, because of its stringent criteria, is rarely used in practice. The proposed classification and measurement framework is inherently biased towards fair value measurement. Financial institutions will be compelled by the proposal to alter their business strategies, investment decisions, product offerings and business activities.

The narrow definition of the hold-to-collect business model may detract from the ability to present useful performance measures and financial information consistent with the banking business model. Financial instruments that are held for the collection of contractual cash flows are not always held to maturity and effective risk management may require sales of financial instruments before an observation of credit deterioration or to reduce concentrations of risk. As importantly, management should not be discouraged from selling financial instruments in response to changing market conditions. Financial reporting based on an accounting oriented business model framework will not accurately portray how the business of banking is performed, thus providing users with a limited or inaccurate understanding of the business activities of a financial institution. It is critically important that the business model concept is appropriately reflected in the final financial instrument accounting standard.

We believe the existing clearly and closely related test³ for evaluation and identification of embedded derivatives provides a superior foundation for the assessment of the cash flow characteristics for a financial instrument. The existing embedded derivative guidance is sufficiently developed, well understood and appropriately applied in practice. In contrast, the newly created SPPI test will require a similar evaluation of embedded terms along with the inevitable development of significant new implementation guidance, requires fair value measurement through net income (even if the embedded terms that do not satisfy the SPPI test are not expected to significantly affect the fair value of the instrument) and will not permit bifurcation. We also have significant concerns that the SPPI test will create or exacerbate accounting measurement mismatches due to the asymmetrical treatment of financial assets and financial liabilities, both at the reporting entity level and between the issuer and holder of the same or similar financial instruments.

While we acknowledge that the current classification and measurement framework has evolved over time, we believe, with few exceptions, that the existing framework produces results that reflect the economic substance of the business activities of a financial institution. Rather than completely overhauling this framework, we believe it is possible to develop a cohesive classification and measurement framework that considers both the business model of an entity and the cash flow characteristics of financial instruments

¹ FASB Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

² The proposed framework requires an assessment of the cash flow characteristics of a financial instrument to determine if cash flows are comprised of solely payments of principal and interest (“SPPI test”)

³ ASC 815-15

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using the current framework as a foundation. We encourage the Boards to consider the following recommendations to improve the proposed classification and measurement framework:

- The default measurement for loans should be amortized cost with the ability to subsequently transfer and measure loans that are held for sale at fair value through net income;
- The default measurement for debt securities should be fair value through other comprehensive income unless they are held for trading purposes or held for the collection of contractual cash flows;
- Expand the hold to collect business model to permit pre-emptive sales in anticipation of an observed deterioration in credit, to reduce concentrations of risk and in response to unanticipated changes in market conditions;
- Retain the clearly and closely related framework to evaluate the cash flow characteristics of financial instruments in lieu of the SPPI test with the option to bifurcate qualifying embedded derivatives;
- Retain the unconditional fair value option;
- Permit the use fair value hedge accounting strategies for all instruments measured at amortized cost; and
- Disclose supplemental fair value information for financial instruments measured at amortized cost rather than the parenthetical fair value information on the face of the balance sheet.

Our specific comments and additional suggestions for improvement to the proposed framework are expressed more fully below.

Business Model

We have the following conceptual concerns with the business model assessment:

- The hold to collect business model should not hinder or direct management decisions: We are concerned that amortized cost measurement will be limited significantly to only those financial assets that are held to maturity. This does not correspond to the economic and business realities inherent in the business of banking. Effective risk management may indeed dictate sales of assets to reduce concentrations of risk (whether by geography, counterparty or product), more efficiently deploy capital and even maximize investor returns when market opportunities arise. Thresholds for concentrations of risk are inherent in credit risk management and established to maximize the collection of contractual cash flows before such cash flows are in jeopardy. While not contemplated at inception, sales of financial assets may also be necessary due to market or competitive factors, or opportunities may arise where harvesting a gain or loss is simply the right thing to do for the company and its investors. The hold to collect business model should not be so restrictive as to effectively prohibit any selling activity. The hold to collect business model definition must be very clear and representative of how business is actually expected to operate in practice. Otherwise, business decisions will be driven by accounting rules rather than the underlying economics.

Lastly, we acknowledge that the proposed guidance permits limited selling activity as a result of a significant decline in creditworthiness; however, at a minimum, effective risk management would require that sales occur, if possible, in advance of such a decline. If the Boards decide to retain the proposed hold to collect business model definition, we strongly encourage the Boards to permit selling activity in advance of any anticipated decline in creditworthiness.

- Hedge accounting should be permitted for debt securities measured at amortized cost: Financial institutions manage exposure to interest rate risk of banking book assets and liabilities in aggregate as part of the asset-liability risk management process. Regardless of the legal form of a financial instrument, the underlying business model or a lack of anticipated selling activity, a financial institution may be subject to interest rate risk, which manifests itself in net interest margin in future

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periods. For example, a financial institution that is subject to interest rate risk when fixed rate financial assets are financed with floating rate debt may employ a fair value hedge accounting strategy in order to maintain net interest margin within a specified range. We agree with the decision of the Boards to permit hedge accounting for loans measured at amortized cost, however, we do not believe the legal form of debt instrument (i.e., loan vs. security) or the assertion that debt securities will be held for the collection of contractual cash flows should prevent hedge accounting.

- The guidance for allocating pools of similar financial assets between the classification and measurement categories may not be operational: The proposed guidance requires fair value measurement through other comprehensive income for individual financial assets that are managed in a business model with the objective to either hold to collect or sell⁴. Conversely, the proposed guidance requires an allocation of pools of similar financial assets between the three classification and measurement categories when, at initial recognition, an entity is unsure whether it will hold to collect or sell⁵. It may not be possible to apply this guidance to pools of similar financial assets in practice. If performed on a percentage basis, partial assets may result; requiring splitting instrument level cash flows between classification categories for the same assets, which is impractical at best. Conversely, if entire individual assets are classified between the three classification and measurement categories, subsequent selling activity may not be consistent with the initial allocation. Given the impracticability of allocating partial assets and the significant limitations on reclassifications between business models, we encourage the Boards to further clarify this guidance.

SPPI Test – General

We have the following overriding conceptual concerns with the assessment of contractual cash flow characteristics:

- The SPPI test does not improve or simplify the existing clearly and closely related framework: The clearly and closely related framework is well-established, well-understood has been vetted by practitioners and preparers, and is conceptually sound across various types of financial instruments. Under the current framework, fair value measurement is required for embedded terms that would otherwise require fair value measurement on stand-alone basis, in other words, the embedded terms meet the definition of a derivative. We believe this principle is superior to the principles underlying the SPPI test, and as such, the current framework remains an appropriate foundation for the assessment of contractual cash flow characteristics. Additional limitations of the SPPI test include:
 - The SPPI test will still require a complex evaluation of contractual cash flow characteristics in a manner that is similar to the clearly and closely related assessment;
 - Although the SPPI test may appear to be simple, the ambiguous nature of the test and complexity of its application to a continually evolving multiplicity of financial instruments and embedded features will inevitably necessitate the development of implementation guidance, whether by standard setters or auditors, similar to and more extensive than existing implementation guidance for the clearly and closely related framework;
 - Because bifurcation will no longer be permitted, fair value measurement of the entire hybrid instrument may be required even when embedded terms are not expected to significantly affect the fair value or cash flows of the instrument; and
 - Separate frameworks to assess the cash flow characteristics for financial assets and financial liabilities creates complexity, as well as asymmetry between issuers and the holders of the same

⁴ Paragraphs 825-10-25-25 in the FASB ED and paragraph 4.1.2A in the IASB ED

⁵ Paragraphs 825-10-25-30 and BC191 in the FASB ED and paragraph B4.1.4, Example 2 in the IASB ED

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financial instrument or between financial liabilities used to fund financial assets with similar financial characteristics.

We encourage the Boards to discard the SPPI test and retain and separately address any concerns with the current clearly and closely framework.

- Many customary lending products and plain-vanilla debt securities may not satisfy the SPPI test: As proposed, many traditional lending products held for the collection of contractual cash flows and plain-vanilla debt instruments not held for trading purposes, including instruments that have embedded features that would otherwise be eligible for bifurcation, may not satisfy the requirements of the SPPI test. The resulting measurement basis, fair value through net income, represents a significant shift from current practice that will not be consistent with the business model associated with these instruments, may adversely impact long-standing risk management strategies and may reduce the availability of lending products and investment opportunities in the market. Given the ambiguity of all aspects of the SPPI test, the sheer multiplicity of financial instruments, the lack of available implementation guidance and the limited ability to assess our portfolio against the requirements of the SPPI test during the comment period, it is difficult to produce a comprehensive list of products that may not satisfy its requirements. However, we have identified the following list of common “plain-vanilla” financial instruments which we believe, without further clarification, have a high risk of failing to satisfy the requirements of the SPPI test.
 - *Consumer loans:*
 - Residential mortgage and other consumer loans that reset based upon the prime rate⁶;
 - Residential mortgage loans that reset based on COSI⁷, CODI⁸ or similar indices;
 - Residential mortgage loans purchased at a premium or discount that are prepayable without penalty at the contractual principal amount, including PCI loans;
 - Consumer loans, typically credit card loans, with introductory interest free periods or low interest rates that reset to higher interest rates in the future; and
 - Student loans indexed to an unobservable, government-determined interest rate subsidy.
 - *Commercial loans:*
 - Loans with interest rate pricing grids established at the date of origination that adjust based on the credit risk of the borrower;
 - Loans where the reset frequency does not match the tenor of the interest rate; loans that reset daily to 1-month LIBOR are quite common; and
 - Loans with features tailored to specific market segments or credit circumstances, such as loans with paid-in-kind (“PIK”) interest features, remote participation options indexed to non-financial instruments⁹ or with increasing penalty payments.

⁶ The prime rate does not have a tenor

⁷ A proprietary rate based on the weighted average interest rates paid on certificates of deposits

⁸ A 12 month moving average of the monthly yields on three-month certificates of deposit as published by the Federal Reserve Board

⁹ These embedded options are typically do not require measurement at fair value through net income as the value of the options are based upon nonfinancial assets not readily convertible to cash or have negligible value.

- *Asset-backed securities:*
 - Potentially all asset backed securities, including conforming mortgage-backed securities as holders may be unable to evaluate whether the cash flows of the underlying asset pool represent solely payments of principal and interest¹⁰;
 - Residential mortgage-backed securities purchased at a premium or discount where the underlying mortgage loans are prepayable without penalty at the contractual principal amount;
 - Securities where the underlying assets consist of consumer loans with low introductory rates or floating-rates indexed to the prime rate;
 - Securities where underlying assets consist of floating-rate consumer loans indexed to an unobservable, government-determined rate, i.e., student loans;
 - All securities that provide credit enhancement to another tranche, i.e., any security other than the most senior tranche;
 - All securities issued by actively managed securitization structures, i.e., collateralized loan obligations and collateralized debt obligations; and
 - Securities where the underlying assets may include non-financial assets such as foreclosed real estate property.

- *Other debt securities:*
 - Perpetual preferred securities where deferred interest payments do not accrue interest; deferred interest commonly does not include “interest on interest”;
 - Debt securities purchased at a premium or discount with call or put options at par;
 - Corporate bonds with typical contingent redemption features, such as “equity claw back feature”¹¹, interest make-whole provisions¹² or change in control provisions¹³;
 - Securities with contingent prepayment features that are exercisable upon a change in regulatory rules; and
 - Investments in funds that are actively managed, i.e., mutual funds, money market funds or similar investment funds.

While this list is extensive, it is not all-inclusive nor does it contemplate new financial instruments that may develop over time. While the application of the SPPI test is clear in some cases and less so in others, we do not believe any of these or similar examples should require fair value measurement through net income in their entirety. We believe this represents a significant departure from the business model principal. Moreover, we do not believe the Boards have adequately explained why such common financial instruments should be measured at fair value through net income. Given the wide range of financial instruments in the marketplace and high likelihood of wide interpretation of the proposed guidance, the development of significant and detailed implementation guidance will be unavoidable. Accordingly, we do not understand why the Boards are proposing to replace rather than refine the current clearly and closely framework.

¹⁰ We have interpreted paragraph 825-10-26 b.1 to require an assessment of all non-derivative underlying financial assets to determine if such instruments have contractual cash flows that are solely payments of principal and interest.

¹¹ Option allows issuer to refinance a certain amount of outstanding bonds (at a repurchase price exceeding par) with proceeds from an equity offering.

¹² Upon redemption or conversion of bonds, issuer is required to pay additional amounts to the investor equal to the remaining contractual interest payments as compensation for foregone interest.

¹³ Upon change in control of the issuer, the investor can put the bond at 101% of par.

- The bifurcation model facilitates effective economic hedging strategies and promotes consistent treatment with other non-hybrid financial instruments: Bifurcation of qualifying embedded feature permits an organization to isolate and hedge the risk inherent within each component of a financial instrument more easily as derivative instruments generally are structured to mitigate a particular risk. Bifurcation of the embedded feature also facilitates more reliable tracking of effectiveness of the hedge relationship. The inability to bifurcate qualifying embedded derivatives may hinder risk management strategies and exacerbate accounting measurement mismatches. For example, companies may use free-standing derivatives to economically hedge bifurcated derivatives, which are typically the primary source of variability of a hybrid instrument. If the entire hybrid instrument is subsequently measured at fair value, the free-standing derivative will not be effective at offsetting the risks of the hybrid instrument. We believe it would be more appropriate to account for the host contract in accordance with the business model underlying hybrid instrument rather than defaulting to fair value measurement through net income. Such a model would promote consistency with other non-hybrid instruments in similar risk management strategies or business models. **We encourage the Boards to retain the option to bifurcate qualifying embedded derivatives.**
- The definition of principal and interest is too narrow: Given the vast array of embedded features and the lack of implementation guidance, considerable differences in practice may result for instruments with similar embedded features. This is due, in part, to the proposed definition of interest and principal. The proposed definition of interest indicates that compensation for the time value of money, credit risk and liquidity risk may be included in the determination of the interest rate of a financial instrument. However, in the basis of conclusions of the recent exposure draft on credit impairment¹⁴, the FASB acknowledges that a component of the interest rate also includes compensation for other market factors. We encourage both Boards to clarify and expand the definition of interest to include credit spread adjustments to facilitate business strategies to expand in particular markets, funding costs, administrative costs and profit margin as it is not operational to precisely decompose the interest rate of a financial instrument to affirm interest cash flows conform to the proposed definition of interest.

In addition, the proposed definition of principal indicates that the principal amount of a financial instrument represents the amount transferred by the holder at initial recognition rather than the face amount of the instrument. This may have unintended consequences for instruments with unconditional prepayment options purchased at a discount or premium that would otherwise satisfy the SPPI test. For example, fair value measurement through net income may be required for a plain-vanilla prepayable mortgage loan purchased at a discount or premium because the loan is prepayable at an amount that is more or less than the amount transferred upon initial recognition. We strongly encourage the Boards to amend the proposed definition of principal to the face amount of the financial instrument or consider the difference between the prepayment amount and the face amount as a component of interest. Such a change would permit more plain-vanilla financial instruments to be measured at amortized cost or fair value through other comprehensive income.

¹⁴ FASB Proposed Accounting Standards Update, Financial Instruments – Credit Losses (Subtopic 825-15), paragraph BC 15

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- Clarification and improvement are necessary if the Boards decide to retain the SPPI test: Several aspects of the SPPI test lack sufficient definition and require further clarification or application guidance:
 - Application of the benchmark instrument concept, and by extension, significance thresholds for insignificant embedded features, to only a subset of embedded features and not all embedded features results in inappropriately providing more weight to the nature of the embedded feature rather than a consistent principle focused on the significance the embedded feature to the changes in cash flows or fair value changes of the entire financial instrument.
 - Reasonably probable outcomes should be considered in the evaluation of all embedded features rather than limited to leverage and interest rate reset features. For example, probability is expressly considered in the evaluation of leverage and interest rate features, disregarded in the evaluation of contingent payments, unclear, as the proposed guidance is silent, in the evaluation prepayment options, extension options and interests in securitizations.
 - Although the proposed guidance suggests each embedded feature should be evaluated independently, the proposed guidance does not address whether multiple embedded features that modify the economic relationship between principal and interest within a single financial asset should be evaluated collectively, independently or both. For example, financial assets may contain (i) multiple embedded features that are individually insignificant, but collectively significant, or conversely, (ii) embedded features that are individually “more than insignificant”, but collectively have offsetting impacts such that the difference between the cash flows of a benchmark instrument and the financial asset under evaluation is insignificant.
 - Clarification is necessary for financial assets with at least one term that modifies the economic relationship between principal and interest that also contain other embedded features, such as a prepayment option or contingent payments. It is not clear whether the benchmark instrument assessment is applicable to these instruments and if so, whether the benchmark instrument should exclude the other embedded features. If the other embedded features should be included, it is unclear whether the evaluation of the other embedded features should disregard probability. For example, consider a financial asset with an embedded non-contingent call option. A decision must be made as to whether the benchmark instrument cash flows should assume extension to the earliest call date, expected call date or contractual maturity. Another derivation of that example includes the same facts except the call is contingently exercisable but the contingency has a low likelihood of occurrence.
 - Clarification is necessary to assess the magnitude and composition of “reasonable additional compensation” for financial assets with embedded prepayment options. For example, it is unclear whether the evaluation of reasonable additional compensation would consider premiums or discounts to the face amounts of financial instruments or penalties payable by a borrower upon repayment. It is also unclear how to perform the assessment of whether such compensation is reasonable. As stated previously in this letter, we believe premiums and discounts should be included in the definition of principal.

SPPI Test – Interests in Securitizations

We have the following conceptual concerns with the assessment of interests in securitizations:

- The framework for the evaluation of exposure to credit risk for interests in securitizations may hinder asset-liability management: Subordination is inherent in many financial assets and is not unique to financial assets created through a securitization or similar transaction. While certain securitization transactions issue instruments that provide subordination to other interests and are subject to credit risk of underlying assets, these concepts are also inherent within many other types of instruments such as corporate debt, collateralized loans, and home equity loans. The proposed guidance implies

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that only the most senior tranches may satisfy the exposure to credit risk evaluation. The banking book of a financial institution typically consists of asset backed securities, not all of which represent the most senior or government guaranteed tranches. Accordingly, many commonly held instruments in the banking book may require fair value measurement through net income. We do not understand why the Boards view instruments with economically similar risks differently and we encourage the Boards to eliminate this requirement.

- If retained, the exposure to credit risk evaluation for interests in securitizations needs clarification: It is unclear whether the exposure to credit risk evaluation¹⁵ should consider actual incurred losses, expected losses, or a hypothetical worst case loss scenario. This assessment is critical in determining whether asset-backed securities would require fair value measurement through net income. For example, if one were required to assume the underlying asset pool experiences a hypothetical worst case loss scenario, only the most senior tranche would qualify for measurement at fair value through other comprehensive income or amortized cost. Many investment-grade asset-backed securities, including some that are rated “AAA”, are not the most senior tranche and may require fair value measurement through net income based on this interpretation. Accordingly, we encourage the Boards to include implementation guidance related to the evaluation of the exposure to credit risk.
- Clarification is necessary for interests in securitizations that contain non-financial instruments: Many securitization vehicles may hold non-financial and financial instruments. For example, commercial or residential mortgage loan securitization structures may include foreclosed real estate properties, typically on a temporary basis as a means to recover the related loan investment. We are concerned that fair value measurement through net income may be required for interests in these securitizations because non-financial assets acquired either at transaction inception or in the future may not be considered contractual cash flows that represent solely payments of principal and interest. We do not believe this was the outcome intended by the Boards and we encourage the Boards to amend the proposed guidance to clarify that that non-financial assets held on a temporary basis for purposes of recovering principal or interest should not violate the SPPI test.
- The “look through” assessment for interests in securitizations is not operational: The SPPI test requires the holder of interests in securitizations to perform an instrument level assessment of underlying financial instruments of the associated securitization structure. However, investors understand and evaluate risks inherent in these interests based on information provided in the associated offering documents, which contain information about the types and the overall management of the underlying assets. However, the offering documents do not include sufficient information to properly assess whether the cash flows of the underlying financial instruments are solely payments of principal and interest as required by the proposal¹⁶. As a result, fair value measurement through net income may be required for most interests in securitizations as it may not be possible to perform this type of assessment.

To illustrate our concern, consider a typical mortgage backed security (“MBS”) where the underlying asset pool contains conforming residential mortgage loans. The holder of the MBS must obtain an understanding of the features of the underlying mortgage loans, such as prepayment options, extension options, rate reset frequency, interest rate benchmark, purchase price, sources of contingent cash flows, and other items to determine whether the requirements of the SPPI test are satisfied. Sufficient information necessary to perform this assessment will not be included in the related

¹⁵ Paragraph 825-10-55-26.c in the FASB ED and paragraph B4.1.21c in the IFRS 9

¹⁶ Paragraphs 825-10-55-26 b.1 and 825-10-55-26 b.2

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offering documents nor would it be practical to perform such an assessment even if the individual loan documents were otherwise available to the investor. If this assessment cannot be performed at the individual underlying instrument level, fair value measurement through net income of the MBS would be required – a conclusion which is at odds with the business model principle.

We do not believe this outcome was intended by the Boards. Accordingly, we encourage the Boards to consider that current guidance requires an assessment of both the contractual terms of interests in securitizations as well as the activities of the securitization structure to determine whether embedded derivatives exist. This analysis requires obtaining an understanding of the nature and amount of the assets, liabilities and other financial instruments, as well as the payoff structure and payment priorities of the securitization structure. We believe this assessment would result in identifying many of the same features as the proposed SPPI test for interests in securitizations without the need to perform an instrument level assessment of the individual underlying assets of the securitization structure. Accordingly, we encourage the Boards to eliminate the “look through” requirement and permit a higher level of assessment similar to current guidance for hybrid interests in securitizations.

- Securitization interests in actively managed pools of underlying assets may unnecessarily require fair value measurement through net income: Fair value measurement is required if the holder of a securitization interest is unable to assess changes to the underlying pool of financial assets against the SPPI test¹⁷ for such interests. However, it will not be possible to satisfy the proposed requirement to assess changes in the composition of the underlying pool of financial instruments for actively managed securitization structures. The reinvestment and hedging parameters governing these structures are typically broadly defined and cannot be assessed against the SPPI test requirements. Examples of such structures include collateralized loan/debt obligation securitizations, structured investment vehicles, credit card securitizations, or asset-backed commercial paper conduits, as well as funds in the asset management industry that issue debt securities that may be considered interests in securitized financial assets such as mutual funds, money market funds or other similar investment funds. We encourage the Boards to reconsider this guidance given the overwhelming bias it has towards measurement at fair value through net income, irrespective of the business model for investing in the security.

Other Concerns with the Proposed Guidance

We have the following additional concerns with the proposed guidance:

- Unconditional Fair Value Option: We believe the elimination of the unconditional fair value option will hinder risk management activities and the unconditional fair value option should be retained. The fair value option is primarily elected to reduce complexity or accounting asymmetry and in our view, an unconditional fair value option is necessary given the complexity inherent in accounting for financial instruments. For example, the fair value option is often elected to facilitate economic hedging of financial assets or financial liabilities that are otherwise measured at amortized cost with financial instruments that do not qualify for hedge accounting. Financial institutions will not be able to economically hedge these and similar risks with the proposed conditional fair value option.
- Customary lending activities: We do not believe that differences between the transaction price and fair value of transactions arising in the course of customary lending activities of financial institutions should be recognized in net income. Financial institutions may offer lending concessions to customers, usually in the form of reduced interest rates to build or improve customer relationships,

¹⁷ Paragraph 825-10-55-27 of the FASB ED and paragraph B4.1.26 of IFRS 9

capture market share or to generate goodwill in their communities. We acknowledge the discussion in the basis for conclusions indicating that an assessment of the transaction price is not applicable to broad-based lending programs because they are “within the realm of normal or customary lending activities”¹⁸. We encourage the Boards to explicitly state within the guidance that differences between the transaction price and fair value in connection with customary lending activities do not require separate recognition in net income.

- Equity method of accounting: The proposed requirement to consider an equity method investment as held for sale if an identified potential exit strategy and associated exit time-line exists is too broad. Although many equity investments may have finite lives, many investments that will not be settled or transferred at fair value may require fair value measurement through net income. Such an outcome would be inconsistent with the underlying business model and economic nature of the investment. Examples of such investments may include tax credit generating investments and other similar joint venture investments. Absent further clarification, we believe all of these types of investments would require fair value measurement through net income.
- Investments in equity instruments: Equity instruments are not only held for resale but also held for long-term dividend investment strategies. While dividends payments are not always contractually required, holding equity investments to benefit from dividend payments is akin to earning interest on a debt instrument. Although the proposed SPPI test would require measurement at fair value through net income, the proposed IASB model permits an irrevocable election to measure certain equity instruments that are not held for trading purposes at fair value through other comprehensive income. The proposed FASB model does not permit such an election. We strongly encourage the FASB to permit fair value measurement through other comprehensive income for equity instruments which will further converge with the IASB proposal and better align the accounting model to risk management and investment strategies.
- Perpetual preferred securities (PPS): Financial institutions typically invest in PPS as core long-term holdings, i.e., for the collection of contractual cash flows. Notwithstanding the legal form of PPS as equity securities, market participants view investment grade PPS as debt securities. PPS have significant debt-like characteristics, including cumulative dividend payments, which are typically based on a floating interest rate such as LIBOR, and callable by the issuer. PPS are traded in the same markets as other fixed income debt securities, are sold based on yield expressed in terms of an index plus a credit spread, and receive credit ratings from the major rating agencies. Accordingly, PPS are managed in a manner similar to and within portfolios of other debt instruments. The proposed framework will require fair value measurement through net income for most, if not all, PPS. Because deferred dividend payments typically do not accrue interest, PPS will not satisfy the requirements of the SPPI test. Likewise, we believe PPS with non-cumulative dividend payments (less common) will not satisfy the requirements of the SPPI test. As a result, financial institutions will likely cease utilizing PPS as a long-term investment option or in asset-liability management strategies. We ask the Boards to consider that these features are not significant to the fair value of the instrument or influential in determining investment decisions. Accordingly, if the Boards decide to retain the SPPI test, we encourage the Boards to amend the proposed implementation guidance for perpetual instruments.

¹⁸ FASB Proposed Accounting Standards Update, Recognition and Measurement of Financial Assets and Financial Liabilities, paragraph BC 155

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- **Nonrecourse liabilities:** We support the proposal to align the measurement of nonrecourse liabilities with the financial assets that will be used to settle the nonrecourse debt. However, we encourage the Boards to also align the measurement of nonrecourse debt with any non-financial assets that will be used to settle the nonrecourse debt as we do not believe the nature of the assets associated with the nonrecourse debt should create accounting mismatches. For example, current nonrecourse debt issued by common consumer and commercial real estate securitization vehicles may contain non-financial instruments in the form of foreclosed real estate property. We are concerned that the existence of the foreclosed real estate would preclude the ability to align the measurement bases of the nonrecourse debt and the assets of the securitization vehicle that will be used to settle the nonrecourse debt. This view is recently supported by the EITF¹⁹ and we encourage the Boards to amend the proposed guidance to align the measurement of nonrecourse liabilities with both the financial and non-financial assets that will be used to settle the nonrecourse debt.
- **Parenthetical fair value disclosures:** Parenthetical disclosure of fair value information on the face of the balance sheet for financial assets measured at amortized cost clutters up, overwhelms and overcomplicates the amount of financial information on the balance sheet and may be misleading to investors and other users. Fair value information for these assets is already required through incremental disclosure in the notes to the financial statements. We are concerned that disclosure of this information on the face of the financial statements will contradict the business model assessment for assets measured at amortized cost and create confusion regarding how such assets should be evaluated. While we agree that fair value information for assets measured at fair value is useful, we do not believe it should be given primacy on the face of the financial statements as implied gains or losses due to changes in fair value may not be realized by the reporting entity. **We encourage the Boards to prepare and review a pro-forma balance sheet of a large financial institution reflecting the impact of the exposure draft.**
- **Level 3 fair value disclosures for instruments measured at amortized cost:** The proposed Level 3 fair value disclosures for assets and liabilities measured at amortized cost provides a significant amount of information with limited value that would take considerable effort to compile and incorporate within the financial statements. As these instruments are managed for the collection of contractual cash flows rather than on a fair value basis, providing disclosures related to changes, overall quality and subjectivity of fair value measurements should not be relevant to users. We believe that the existing credit quality disclosures should be adequate to provide users with sufficient information about the risks inherent in these instruments. As a result, we ask the Boards eliminate the Level 3 fair value disclosures for financial instruments measured at amortized cost.
- **Deposit liability disclosures:** We have the following concerns with the proposed deposit liability disclosures:
 - The FASB should not attempt to codify the definition of core deposits. The term ‘core deposit’ is used throughout the financial services industry to describe a low-cost source of stable funding. Currently, core deposits of financial institutions include most demand deposits and certain time deposits. A codified accounting definition of the term that differs from the current industry definition will create inconsistent disclosures and unnecessary confusion for investors, regulators and other financial statement users.
 - We do not believe it is appropriate to require disclosure of proprietary information such as the all-in-cost-to-service rate and weighted-average maturity. The Board should be particularly mindful

¹⁹ Emerging Issues Task Force project 12-G, *Accounting for the Excess in Fair Value of Assets over Liabilities of a Consolidated Collateralized Financing Entity*

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of this issue as the proposed disclosures will in appropriately provide users and competitors with expectations of deposit business strategies and depositor behavior. For example, the disclosure of the all-in-cost-to-service rate and weighted-average maturity for deposits requires the use of assumptions about non-contractual attrition and deposit rate response. Revealing this information may compromise the competitive advantage of a financial institution, as competition for customers is based, in part, on a combination of service and rate.

- Recycling of changes in own credit risk: We believe the decision to permit the election to recognize changes in own credit risk in other comprehensive income for financial liabilities measured pursuant to the fair value option is a significant improvement to current accounting. We also support the FASB proposal to recognize these changes in earnings upon settlement of the liability rather than transferred within equity. We encourage the IASB to amend its proposed guidance to conform to the FASB proposal.
- Transition and effective date: Given the complex and pervasive nature of the proposed guidance we request a 3 year transition period from the effective date to implement the final guidance and should be aligned with the effective date of the Proposed ASU on credit impairment.

Conclusion

While we support a classification and measurement framework for financial instruments that considers both the business model of an entity as well as the cash flow characteristics of a financial instrument, we have several conceptual concerns with the proposed classification and measurement framework. We are concerned that the proposed business model definitions will significantly limit the use of amortized cost for many traditional held for investment lending products. We are also concerned that the SPPI test is fatally flawed and will significantly increase the use of fair value measurement for both customary lending products and plain-vanilla debt securities. While this may not have been the intention of the Boards, it has been well established that the majority of users and preparers do not support the use of fair value as the primary measurement attribute. We believe the proposed framework will generate financial results and disclosures that are inconsistent with the economic characteristics of the underlying financial instruments and business strategies, may undermine risk management practices and adversely impact the availability of lending products and investment options. We encourage the Boards to revisit the proposed framework and incorporate our recommendations within this letter.

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We appreciate the opportunity to comment on the issues contained in the proposed guidance. If you have any questions, please contact me at 415-222-3119.

Sincerely,

/s/ Richard D. Levy

Richard D. Levy
Executive Vice President & Controller

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cc: Paul Beswick – Securities and Exchange Commission
Kathy Murphy – Office of the Comptroller of the Currency
Stephen Merriett – Federal Reserve Board
Robert Storch – Federal Deposit Insurance Corporation
Donna Fisher – American Bankers Association
David Wagner – The Clearing House