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May 14, 2013

Ms. Leslie Seidman
Chairman
401 Merritt 7
PO Box 5116
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Re: File Reference No. 2013-220 - Proposed Accounting Standards Update: Financial Instruments - Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities

Dear Ms. Seidman:

Goldman Sachs appreciates the opportunity to provide comments on the Financial Accounting Standards Board's (the "Board") proposed accounting standards update "Recognition and Measurement of Financial Assets and Liabilities" (the "proposed Update").

We commend the Board on its efforts to converge with the IASB on a topic so fundamental to financial institutions. We believe convergence is essential in our current global economy and we ask the Board to continue to work towards a converged approach that achieves an improvement in U.S. financial reporting. However, we have significant concerns about the proposed Update, described in detail below and do not support its issuance as currently drafted.

<u>An Unconditional FVO is needed to Address Model Imperfections and Complexity</u>

Our primary concern is the loss of the unconditional fair value option (FVO). In a perfect world, an unconditional FVO would not be needed because the Board's classification and measurement model (the "model") would generate the appropriate outcome all the time. In reality, no model – however robust and complex – can capture all potential scenarios where the FVO would be a better approach for a specific financial instrument than the model. The FVO is generally used to align the accounting with the risk management approach and reduce complexity. We believe the FVO will always be a necessary tool for when the existing accounting literature does not require or permit the use of fair value – net income (FVNI) accounting. We are not aware of problems with the use of the FVO (other than the own

credit risk issue which the Board has addressed) and believe the benefits of an unconditional FVO far outweigh any perceived costs.

Improving Robustness and Reducing Complexity of the Model

We are also concerned with the rules-based application guidance underlying the proposed framework for financial assets. While we support the principles of the proposed Update – an accounting framework based on cash flow variability and business models, the principles have been negated by the application guidance. As a result, the model is not as robust as it could be because it doesn't properly reflect how an entity manages its business and the variability of its cash flows. For example, assets managed on a fair value basis would not be accounted for at FVNI because of the application guidance and proposed limitations to the existing FVO and assets with insignificant cash flow variability that are managed for the collection of cash flows likely would be accounted for at FVNI. Moreover, the proposed Update does not simplify the current framework; rather, it replaces existing complexity with new complexity. We believe the application guidance – where to draw the lines on cash flow variability and asset sales – needs further work with an eye towards making the model more robust and simpler to apply.

Presentation of Instrument-Specific Credit Risk in OCI for FVO Liabilities

We applaud the Board's decision to classify in other comprehensive income changes in fair value due to own credit on liabilities at fair value under the fair value option. We also support the Board's decision to limit this classification approach to recourse debt, recognized at fair value under the fair value option, because settlement will be generally at par. In contrast, the own credit adjustment relating to free-standing derivatives is realizable and should therefore continue to be included in net income. It also is linked to derivative valuations as a whole, for example, a single at-the-money OTC uncollateralized derivative with zero fair value at trade inception has both asset-side and liability-side credit valuation adjustments because of future potential credit exposures.

We ask the Board to expand the scope of this presentation requirement to non-financial hybrid liabilities elected under the fair value option provided in paragraph 825-30-15-5 of the proposed Update. As the Board is aware, these instruments are comprised of financial and non-financial components where the changes in fair value relating to the financial component is exposed to the same instrument specific credit risk as a hybrid financial liability and settlement also will be generally at par.

We provided more detailed comments on these key issues in the attached Appendix to this letter.

Thank you for the opportunity to provide our views. If you have any questions or would like to discuss any of these comments further, please contact me at 212-357-8437; matthew.schroeder@gs.com).

Sincerely,

Matthew L. Schroeder

Appendix

Unconditional Fair Value Option

We strongly oppose the Board's decision to limit the unconditional fair value option. We acknowledge the Board's position that unconditional options may reduce comparability. However, we believe the advantages of an unconditional fair value option significantly outweigh any potential concerns. No model is perfect and therefore, the fair value option is a necessary tool used to avoid earnings mismatches and reduce complexity. It also provides flexibility to encompass different risk management strategies where other tools such as hedge accounting generally aren't available.

The limited fair value option provided in the proposed Update, while helpful, cannot capture all potential examples of where FVNI accounting would be a better approach to accounting for a specific financial instrument. The following are just a few examples of situations where we believe the availability of an unconditional fair value option for financial assets and financial liabilities would achieve better financial reporting, however, we would be required to follow an alternative accounting model that will create an accounting mismatch and/or complexity under the proposed Update:

Fair Value Option – Financial Assets:

We may have loans or securities that meet the criteria for classification as amortized cost but are risk managed through the use of derivatives or other financial instruments at fair value. It is unclear to us, absent the unconditional fair value option, whether in all cases we would be able to fair value these loans and securities under the proposed framework. An unconditional fair value option would simplify the analysis.

It is unclear to us how to analyse under the proposed framework, the classification for financial assets that meet the SPPI test and are held in a consolidated securitization entity under a hold for collection of cash flows strategy (e.g., a static pool of loans) but the investment in the consolidated subsidiary is viewed internally as a trading asset (notwithstanding its intercompany nature.) We believe the availability of the fair value option election for the assets and liabilities of the consolidated entity would be the simple solution. We note that the proposed conditional fair value option in paragraph 825-30-15-2 of the proposed Update will not always be available as a remedy because the SPV may hold some non-financial assets due to foreclosure.

We also do not support the proposed model for accounting for equity method investments. We believe the existing model of equity method accounting coupled with the fair value option isn't broken and should be retained. Under the current framework, entities choose the most appropriate accounting model for an equity method investment that aligns with their business strategy and risk management approach. While we believe the proposed model for equity method investments held for sale would capture many equity method investments that would otherwise be fair valued under the unconditional fair value option today, there are exceptions. For example, a joint venture arrangement investing in a mix of financial and non-financial assets may be managed on a fair value basis without a defined exit strategy and therefore, will not meet the requirement for fair value accounting. We also often elect the fair value option for equity method investments that are not held for sale to reduce complexity or is necessary, when financial statements needed to report under the equity method of

accounting are available only with considerable delay, as is often the case with private companies in foreign jurisdictions.

If the Board disagrees with our recommendation above, we believe the application of the held for sale rule need to be clarified. The proposed Update doesn't provide guidance on the accounting for a subsequent change in strategy for an investment that doesn't initially meet the held for sale criteria. Additionally, it is unclear whether there would be a tainting concept for new investments if initial exit strategies are not met.

Fair Value Option – Financial Liabilities:
We support the Board's proposed retention of amortized cost as the default measurement for financial liabilities. Additionally, we support retention of the requirement to bifurcate an embedded derivative that is not clearly and closely related to the host contract and measure the bifurcated embedded derivative separately.

We do not, however, support the narrow limitation of the fair value option to hybrid financial liabilities that contain embedded derivatives and to groups of financial assets and financial liabilities managed on a net fair value basis. In addition to eliminating the ability to avoid the complexities of hedge accounting, the loss of the unconditional fair value option would also create significant accounting mismatches between derivatives used to economically hedge risks that are difficult (or impossible) to hedge within the current hedge accounting model, for example, callable debt and debt issued in emerging markets that do not have a local interest rate that meets the definition of a "benchmark interest rate," as further explained below:

- Callable debt. Many companies issue fixed rate debt with an embedded call option (i.e., call monetization strategies). The embedded call option in the debt is "clearly and closely" related and is not ordinarily bifurcated from the debt host. ASC Topic 815 permits application of fair value hedge accounting to callable debt issuances; however, in practice, hedges of callable debt seldom meet the requirements to be considered "highly effective." Therefore, to effectively manage the fair value risk inherent in the issued callable debt and avoid an accounting mismatch between the hedging derivative and hedged debt, issuers must elect the fair value option for the callable debt.

- Debt issued in emerging markets. Debt capital markets continue to develop in emerging market economies around the world. While investor demand may justify a locally denominated issuance, the local market may not have a sufficiently developed benchmark interest rate that would be eligible for formal designation in a hedge of interest rate risk. To effectively manage the fair value risk inherent in the foreign currency denominated debt and avoid an accounting mismatch between the hedging derivative and the hedged debt, issuers must elect the fair value option for the emerging market debt.

Furthermore, risk managers do not view risks that are eligible for bifurcation from a debt host separately from risks that are not eligible for bifurcation. The accounting model for financial instruments must permit issuers to manage risk in the most economically efficient manner possible, whether through the hedge accounting model or on a fair value basis. The fair value option limitations and resulting accounting mismatches proposed by the Board would severely limit the ability of issuers to manage many risks on a fair value basis. These

limitations would not simply make hedging certain risks more inconvenient, but rather could fundamentally change the economics associated with certain debt issuances which the existing accounting model faithfully portrayed and potentially negatively affect debt products available for issuance in the market.

We note that the proposed conditional fair value option in paragraph 825-30-15-2 of the proposed Update will not always be available as a remedy because even if the entity manages these liabilities and the related hedge on a net risk basis and provides this information to management, this conditional fair value option is limited to "groups of financial assets and liabilities." In many cases, the embedded risk in the financial liability may be in a net gain position (asset) and the offsetting hedge, a liability.

The proposed Update needs to clarify whether the accounting for non-recourse liabilities described in paragraph 825-10-35-11 would continue to be effective if the linked financial assets subsequently are exchanged for non-financial assets in lieu of payment. We believe the availability of an unconditional fair value option would be a simpler approach.

Another example of why the unconditional FVO should be retained is non-recourse liabilities secured by non-financial assets, such as real estate. Electing the FVO avoids a potential mismatch in earnings if the real estate is impaired below the reporting entity's at-risk investment in the real estate. If the current FVO is not allowed, an entity could be faced with the situation of recording non-economic losses if impairments exceed the entity's at-risk investment.

We believe the scope of the current fair value option model is appropriate, and in conjunction with the required disclosures under Topic 825 allow issuers to manage risk in the most economically efficient way possible, minimize accounting mismatches, provide users with decision-useful information, and facilitate comparability.

If the Board disagrees and continues to support a limited fair value option, we ask that the limited fair value option be expanded to converge with the IASB on this issue as the existing IASB model takes into consideration whether an asset is managed on a fair value basis and accounting mismatch. Additionally, we would want the effective date of this proposal to be aligned with the proposed changes to hedge accounting. We expect the operational burden of adopting this proposed Update and the related proposed changes to the impairment model for financial instruments to increase significantly for us without the benefit of an unconditional fair value option as a way to reduce accounting complexity.

<u>Solely Payments of Principal and Interest (SPPI) Test</u>
We believe the test for whether contractual cash flows are <u>solely</u> payments of principal and interest is fatally flawed. We do not believe insignificant cash flow characteristics should drive the accounting measurement of a debt instrument. We are also very concerned that the model for determining cash flow variability in the proposed Update will probably lead to practice issues that could result in material "foot fault" misstatements. The problem lies in the proposed Update's strict requirement that cash flows represent solely principal and interest. Under the current proposal, a potential misclassification of a debt instrument because a relatively insignificant embedded feature was overlooked could cause a material misstatement because changes in fair value of the *entire* instrument would be reported in net income (rather than just the change due to the feature). As a result, entities will have to implement costly internal control systems to mitigate this risk which will be operationally

burdensome. Additionally, under the proposed Update, the unconditional fair value option wouldn't be available to reduce this accounting complexity. Under the existing framework, such features (to the extent bifurcatable) would be captured because of the ability to bifurcate an embedded derivative and measured at FVNI while the host continues to be recognized at amortized cost.

We also do not support the proposed cash flow characteristic test for securitization interests, which require entities to "peek inside" the securitization vehicle. We believe this requirement is inconsistent with the cash flow characteristics test for non-securitized debt instruments that are economically similar, for example, corporate bonds with similar credit ratings and levels of subordination. A separate model for securitization interests is inconsistent with the Board's stated objective of a "consistent comprehensive framework for financial assets."

For all the reasons described above, we support retaining the existing "clearly and closely related" test under ASC 815 along with the concept of bifurcating embedded derivatives. The clearly and closely related test is an existing model for determining cash flow variability of financial instruments that require measurement through FVNI. While we acknowledge that these concepts are complex, they involve less complexity than the SPPI test and are time-tested with practice issues having surfaced over the years and resolved.

Business Model for Financial Assets – Amortized Cost

We are concerned that the restrictive nature of the amortized cost category renders it non-operational, particularly for loans. It appears to be modelled from the held-to-maturity classification under the existing framework for debt securities and therefore has all the practical issues of that accounting framework with the additional complications of trying to apply such a model to loans. We recommend that the Board remove the rules-based guidance on when sales of financial assets in this category are appropriate. Businesses need the flexibility to sell specific assets for risk management reasons that cannot be adequately prescribed by the Board but are wholly consistent with a held-to-collect strategy and are not for reasons that are consistent with the business model described for fair value through OCI assets or FVNI. We believe retaining the existing model for loans held for sale at lower of cost or fair value for sales of assets out of this category should address any concerns about managing the assets for other than a hold-to-collect strategy. We agree that reclassification of assets out of this category should be infrequent.

Pro-rata Allocation of Individual or Pools of Loans or Loan Commitments

The proposed Update, paragraph 825-10-25-30, allows for allocation on a pro-rata basis, the classification of pools of receivables for which multiple business strategies apply but specific assets have not yet been identified under a specific strategy. We agree with the conclusion but are concerned that it will be non-operational when initial allocations are subsequently trued-up, given the onerous restrictions on sales in the amortized cost bucket. To make this operational, the Board should clarify that subsequent true-ups will not be inconsistent with classification at amortized cost.

We are also concerned that the proposed Update doesn't allow allocation of individual loans across business models. The proposed Update requires application of the model for financial assets on an instrument by instrument basis. While this approach works for unitized financial assets such as securities, it does not work for loans and therefore is a fatal flaw. Loans and loan commitments held by multiple parties, especially syndicated loans, are typically subject

to a single credit agreement managed by an administrative agent. Each lender of record takes a pro-rata interest in the facility. Pro-rata interests can be traded and a record of ownership is maintained by the administrator. For large loans and loan commitments, a financial institution frequently holds interests in the same facility under multiple business strategies. For example, a trading desk may buy and sell portions of a loan or loan commitment in the secondary market, while another business unit will purchase an interest with a hold-to-collect strategy. The bank's pro-rata interests held by different business units are one legal contract but managed as if they were separate unitized interests. Additionally, the syndicating/originating bank may originate a loan commitment with the intent to distribute only a portion of the commitment/funded loan. Under current GAAP, such facilities would be classified under held for investment/held for sale on a pro-rata basis. We ask that the Board allow for a similar allocation under the proposed Update. We believe that conceptually, the Board supported this approach for pools of receivables which may be viewed as one unit of account.

Although, not currently available, we note that this is a practice issue that exists under the fair value option today. We believe availability of the fair value option for pro-rata interests in such syndicated loans would also eliminate an accounting mismatch where hedge accounting isn't otherwise available.

Loan Commitments - Other:
We agree with the Board's decision to classify and measure loan commitments based on the business strategy of the funded loans. However, we believe excluding loan commitments that are remote of funding from the scope of the proposed Update is a fatal flaw. Whether a loan commitment is expected to fund is irrelevant to the business strategy and related risk management of the loan. Loan commitments, especially commercial revolving lines of credit, that are remote of funding can be held for collection of cash flows, held for sale, or managed and hedged on a fair value basis. In fact, the credit profile of a borrower can change or the overall economic conditions and therefore, the expectation of funding may change through the life of a loan commitment. As such, we see no reason why there is an exception to the general model for loan commitments that are remote of funding. We agree that the fees on loan commitments held at amortized cost that are remote of funding should continue to follow the guidance in subtopic 310-20 as per Paragraph 825-10-35-21 of the proposed Update.

The proposed Update does not provide any guidance on the classification and measurement for such loan commitments if it does in fact fund and it's unclear to us whether under the proposed Update, a loan commitment for which funding is remote is under the initial measurement clause of paragraph 825-10-30-4 or whether such loan commitments under this framework would be subject to the proposed expected credit loss model. For the reasons described above, we believe the model under the proposed Update for loan commitments that are remote of funding must be amended or clarified.

Disclosures – Core Deposit Liabilities
We have significant conceptual and operational concerns around the proposed disclosures for core deposit liabilities and recommend that they be discarded. The Board received and acknowledged in the basis for conclusions, paragraph BC 310 of the proposed Update, feedback from constituents on the ample concerns around calculating these metrics and the fact that the inputs underlying the disclosure will not be comparable amongst financial institutions. It is unclear to us why the Board believes disclosure of the calculations

underlying the original proposal will be any more valuable. However, if the Board disagrees, we believe that it is premature to include a liquidity-related disclosure through the proposed Update prior to revisiting the liquidity disclosure framework and we ask the Board to defer these disclosures for reconsideration as part of that project.

Disclosures - Other
We believe a disclosure of the amortized cost for debt recognized at fair value is irrelevant and would be operationally burdensome to compute as we would have to maintain two sets of books. We believe that disclosure of the amount the fair value liability would settle at maturity would be more appropriate.

Other
Scope Exception for Broker-Dealers and Investment Companies
We support the scope exceptions in the proposed Update for broker dealer entities and investment companies. We believe that industry specific guidance requires measurement and classification for financial instruments that generally align, in principle, with the framework of the proposed Update. We believe that if such assets were subject to the scope of the proposed Update, the accounting result would not be different. However, for simplification and clarity, we believe a scope exception is useful.

Transition and Effective Date:
We generally agree that a cumulative effect adjustment approach is appropriate for this proposed Update and we agree that the transition adjustment should be for the first balance sheet after the effective date. However, given our significant concerns with the proposed Update as issued, there may be unintended consequences we have not fully vetted. As a result, we believe limited re-exposure of the transition provisions may be necessary depending on the Board's redeliberation of our key concerns. For example, for equity method investments currently elected under the FVO, we believe prospective adoption will be necessary in many cases where the financial information to report under equity method aren't readily available (e.g.; US GAAP financials weren't negotiated as part of the investment given the availability of an FVO).

Given the limited fair value option in the proposed Update and the expected operational complexity of adopting the proposed Update in its current form, we ask that the effective date be no earlier than three years after the financial standard is issued. We believe the transition guidance require the following clarifications:

- Paragraph 825-10-65-2d needs to be amended as follows: "….However, early adoption of the presentation requirement only applies to those ~~hybrid~~ financial liabilities that would qualify and be measured at fair value with changes in fair value recognized in net income as if an entity had elected the fair value option in paragraphs 825-30-15-2 through 15-3. We note that paragraph 825-30-15-2 is not limited to "hybrid" financial liabilities." We also request expansion of this paragraph to hybrid non-financial liabilities elected under the fair value option.

We recommend that reclassification of financial instruments upon adoption of the proposed Update should align with the reclassification guidance in paragraph 825-10-35-23 of the proposed Update. Additionally, paragraph 825-10-62-2b should be as follows: "An entity shall apply the pending content that links to this paragraph by means of a cumulative-effect adjustment to the statement of financial position, including other comprehensive income,

when applicable, as of the beginning of the first reporting period in which the guidance is effective.