

May 15, 2013

Ms. Susan M. Cospers  
Director of Technical Application and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**Re: File Reference Number 2013-220, Proposed Accounting Standards Update, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities**

Dear Ms. Cospers,

The International Swaps and Derivatives Association's (ISDA) Accounting Policy Committee<sup>1</sup> appreciates the opportunity to provide comments and responses to the Financial Accounting Standards Board ("FASB" or the "Board") on the proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* (the "Update"). This letter (i) provides our organization's overall views on the proposed Update and (ii) addresses select questions for respondents included within the proposed Update that are of greater interest to our members.

ISDA is supportive of the FASB's efforts to simplify the accounting for financial instruments with one comprehensive model and to more closely align that model with International Financial Reporting Standards (IFRS). ISDA generally agrees with the principle that an entity shall classify and measure its financial assets based on (i) the contractual cash flow characteristics of a financial asset and (ii) the business model in which the asset is managed.

However, our members have concerns that the proposed recognition and measurement model may increase complexity and result in guidance that is not an improvement over existing U.S. GAAP. There are select aspects of the proposed Update that we believe need further clarification or reconsideration. We strongly encourage the Board to work with the International Accounting Standards Board to develop a converged model based on the recommendations included in this letter.

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<sup>1</sup> ISDA's Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.



We wish to highlight the following observations about the proposed Update that we believe the Board should consider further in its deliberations:

1. We recommend that the Board revisit the contractual cash flow characteristics assessment. We believe standard contractual features in many plain-vanilla financial instruments may not meet the “solely payments of principal and interest” threshold test (“SPPI test”) and the application of the test may not be applied consistently within the industry.
2. We request that the Board consider either replacing the SPPI test with the “clearly and closely related” embedded derivative guidance in Topic 815 or amending the SPPI test so that it is based on a cohesive principle rather than on specific rules with potentially inconsistent application guidance. We recommend the clearly-and-closely-related test because it is well understood and its application in the industry is consistent.
3. We request that the Board allow bifurcation of embedded derivatives from hybrid financial assets to the extent those features do not meet the cash flow characteristics criterion (either in the finalized SPPI test or existing clearly-and-closely-related test). A model that requires fair value accounting for the entire hybrid financial asset when the cash flow characteristics criterion is not met may lead to potential restatement risk and is inconsistent with the proposed model for hybrid financial liabilities.
4. We recommend that the Board reconsider the application of the fair value option to both financial assets and financial liabilities. Our members strongly support a preparer’s ability to unconditionally elect to measure financial assets and financial liabilities at fair value through net income upon initial recognition. This accounting policy is operational in the current environment and will help reduce complexity in implementing a new accounting model for financial instruments. Further, disclosures provide transparency in its use, and we are not aware of any actual or perceived abuses of the fair value option.
5. We strongly agree with the requirement to record the portion of the changes in fair value of a financial liability measured at fair value through net income related to changes in the entity’s own credit risk to be recognized in other comprehensive income and with the Board’s decision to permit early adoption of these amendments.
6. We are concerned about the requirement to look through securitized beneficial interests to the underlying collateral pool to determine whether the SPPI test is met given the operational complexity. We recommend the Board incorporate a provision that requires an entity to evaluate the contractual terms of senior beneficial interests that are of a certain credit quality (e.g., rated AA or better as is commonly applied to determine whether a beneficial interest is within the scope of Subtopic 325-40 (formerly EITF 99-20)) under the cash flow characteristics criterion at the beneficial interest level, not by looking through to the individual assets in the underlying pool. All other secured beneficial interests would be measured at fair value through net income.
7. We believe the equity method of accounting under current accounting guidance, in conjunction with an unconditional fair value option, is the most appropriate accounting model for equity investments when the investor has the ability to exercise significant influence. This model allows an entity to reflect its business strategy with respect to the investment. We are concerned that the proposed model for equity-method investments

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that are “held for sale” is not an improvement over existing U.S. GAAP as it would result in investments carried at fair value when that is not consistent with the business strategy with respect to the investment.

We believe addressing the above observations would further strengthen current guidance and lead to less complexity in practice.

Additional details regarding the above observations and our responses to the specific questions raised in the proposed Update are included in the following attachment.

We hope you find ISDA’s comments and responses informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter please do not hesitate to contact the undersigned.

A handwritten signature in black ink that reads "Daniel Palomaki". The signature is written in a cursive, flowing style.

Daniel Palomaki  
Citigroup  
*Chair, N.A. Accounting Policy Committee*

## Appendix

### Responses to Questions for Respondents

#### Question 1

Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments should be included or excluded from the guidance in this proposed Update and why?

#### Question 2

Do you agree with the industry-specific specialized guidance scope exceptions in paragraph 825-10-15-9? If not, why? What would you propose instead?

We agree with the scope of financial instruments included in the proposed Update, including retaining the industry-specific specialized guidance scope exceptions in paragraph 825-10-15-9.

#### Question 3

The proposed amendments would require an entity to classify financial assets into the appropriate subsequent measurement category (that is, at amortized cost, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at fair value with all changes in fair value recognized in net income) on the basis of the contractual cash flow characteristics of the instrument and the business model within which financial assets are managed.

Does the classification of financial assets based on the cash flow characteristics and the business model assessment provide decision-useful information? If yes, how will this classification influence your analysis of the entity? If not, why?

ISDA agrees with the principle that financial assets should be classified on the basis of the asset's cash flow characteristics and an entity's business model. However, we believe the proposed model for evaluating the contractual cash flow characteristics of a financial asset will add unnecessary complexity without providing more decision-useful information for investors as compared to current U.S. GAAP. Please see our specific recommendations in Question 4 below.

#### Question 4

Do the proposed amendments appropriately convey the principle associated with the contractual cash flow characteristics assessment? If not, why? What would you propose instead?

ISDA does not believe that the proposed cash flow characteristics assessment achieves the stated goal of providing faithfully representative and decision-useful information to investors while reducing complexity for preparers. Therefore, we recommend the Board consider implementing the following proposals, in order of preference:

- *Alternative 1: Replace the SPPI test with the existing clearly-and-closely-related framework under Topic 815.* We request that the Board replace the SPPI test with the clearly-and-closely-related guidance in Topic 815 for assessing the cash flow characteristics of a financial instrument. The existing model in Topic 815 is well understood, operational, less complex than the proposed SPPI test, and is consistent with the Board's proposed model for hybrid financial liabilities. Consistent with the FASB's initial conclusions described in paragraph BC195, we recommend that the Board retain the existing bifurcation requirements in Topic 815 for both hybrid financial assets and

hybrid financial liabilities. We also recommend the Board consider revising the guidance in paragraph 815-15-25-26(b) to require consideration of reasonably possible interest rate scenarios as opposed to all possible scenarios, consistent with the proposed guidance for assessing the significance of a contractual term that modifies the economic relationship of a financial asset in paragraph 825-10-55-20 of the proposed Update. Additionally, if an embedded feature requires bifurcation under Topic 815, we believe an entity should have the ability to elect the fair value option for the entire hybrid instrument, consistent with current U.S. GAAP, in order to align the accounting with an entity's business management strategy.

- *Alternative 2: Retain SPPI test with suggested improvements*  
If the Board decides not to accept Alternative 1, our members recommend building on the principles of the SPPI assessment with certain improvements to the model. In order to reduce complexity, the SPPI test should be based on a qualitative analysis of whether an instrument has contractual cash flows that are *primarily* payments of principal and interest (PPPI) and to require bifurcation of the embedded feature(s) that caused the financial asset to fail the cash flow characteristics criterion. Only if a qualitative test was inconclusive would a quantitative test be required. Our more detailed suggestions are discussed in our responses to Questions 7 and 8. Similar to Alternative 1, if an embedded feature requires bifurcation under the cash flow characteristics assessment, we believe an entity should have the ability to elect the fair value option for the entire hybrid instrument. A few of our members support this alternative as their first preference.

If the Board decides not to accept either Alternative 1 or Alternative 2, at a minimum, we believe that the Board should consider retaining the SPPI test with the suggested improvements described in Alternative 2 and our responses to Questions 7 and 8, excluding bifurcation of embedded features.

**Question 5**

The proposed amendments define principal as the amount transferred by the holder at initial recognition. Should the definition of principal be expanded to include repayment of the principal amount at maturity or other settlement? If so, what instruments would fail (or pass) the contractual cash flow characteristics criterion as a result of this change?

We are generally in favor of an expanded definition that includes repayment of the principal amount at maturity or other settlement but request that the Board clarify the definition of "other settlement." Without clarification, we are unsure how to fully assess the impact of the expanded definition. If the Board does not expand the definition of principal to include the amount exchanged at maturity, some instruments will fail the cash flow characteristics criterion and will be classified as fair value through net income. For example, a purchased credit impaired loan (a "PCI loan") is often purchased at a substantial discount to par. If the loan contains a call feature that allows the loan to be prepaid at par, or at par plus a make-whole provision, it would likely fail the contractual cash flows characteristics criterion.

We suggest that the Board also expand the definition of interest to include consideration for factors other than the time value of money and credit risk, such as funding costs and profit margin.

Question 7

Should a financial asset with a contractual term that modifies the economic relationship (see paragraphs 825-10-55-17 through 55-20) between principal and interest be considered to contain cash flows that are solely payments of principal and interest? Should this be the case if, and only if, the contractual cash flows could or could not be more than insignificantly different from the benchmark cash flows as discussed in paragraph 825-10-55-19? If not, why? What would you propose instead?

We agree that a contractual term that significantly modifies the economic relationship between principal and interest should generally prevent an entity from classifying a financial asset at amortized cost or fair value with qualifying changes in fair value recognized in other comprehensive income. However, as described in Question 4 above, we believe the determination of whether a contractual term that modifies the economic relationship between principal and interest should be based on the existing clearly-and-closely-related guidance in Topic 815, which is well understood and operational.

We believe that the SPPI guidance, as proposed, will lead to counter-intuitive classification results, inconsistent application in practice, and significant potential restatement risk. If the Board decides not to pursue Alternative 1 as suggested in Question 4, we request that the Board make the improvements suggested in our response to Question 8 below.

The proposed SPPI guidance prohibits bifurcation of embedded derivatives from financial assets and requires financial assets that contain a contractual term that modifies the economic relationship between principal and interest be classified as fair value through net income in their entirety. The detailed nature of the SPPI test increases the risk that an entity misses a non-substantive feature and improperly classifies a financial asset upon initial recognition. If a non-SPPI feature is subsequently identified, the entity may be required to reclassify the financial asset in its entirety to the fair value through net income category, resulting in potentially material adjustments to previously reported information and the need to restate. Shortly after the adoption of Topic 815, restatements increased significantly due to the complexity of the new hedge accounting rules. We see an analogous situation in the future as preparers later determine current (or future) standard provisions (which by themselves are not significant features of the financial instrument) require fair value accounting for instruments previously reported. We believe the current bifurcation guidance is more easily understood and is consistent with the Board's initial objective to require fair value accounting of embedded derivatives separate from their host instruments.

Overall, we believe the consideration of the cash flow characteristics should follow a cohesive principle rather than detailed and potentially inconsistent application guidance. If the Board retains the SPPI test, we would recommend certain changes that would achieve more conceptually sound results for instruments managed within a business model that permits classification as either amortized cost or fair value through other comprehensive income and would simplify the application of the test. As currently proposed, an entity would be required to consider any embedded features of an instrument based on a narrow and rules-based interpretation of what qualifies as a modification that would cause the instrument to fail the SPPI test, irrespective of either the significance of the embedded feature on the fair value or the expected cash flows or the likelihood that the embedded feature will be triggered and actually modify the cash flows. The application guidance on interest rate resets or leverage situations requires an entity only to consider "reasonably possible scenarios rather than every possible scenario," whereas the application guidance related to contingent features prohibits an entity from



considering the probability that the contingent event will actually occur. We believe the “reasonably possible” application guidance related to interest rate and leverage features should be extended to any embedded feature, including contingent features. Additionally, we believe the threshold should be referred to as “*primarily* payments of principal and interest” so that it does not imply that an insignificant modification to the contractual cash flows would be inconsistent with the cash flow characteristics criterion.

Further, an assessment of the cash flow characteristics could be necessary for instruments with even a slight degree of complexity and would require identification of a reliable (or determination of a hypothetical) benchmark instrument. Therefore, we propose that a qualitative consideration of whether the cash flow characteristics of an instrument are primarily payments of principal and interest precede the quantitative requirement to compare the cash flows of the modified instrument to those of a benchmark instrument. The qualitative assessment would consider the significance of the embedded feature to the hybrid instrument and also the likelihood of the feature to impact the cash flows. This qualitative approach would alleviate the need for extensive and instrument-specific guidance or exemptions. A quantitative assessment on an instrument-by-instrument basis should only be required if a qualitative assessment cannot be made.

**Question 8**

Do the proposed amendments contain sufficient application guidance in paragraphs 825-10-55-17 through 55-20 on assessing a modified economic relationship? If not, why? What instruments would fail (or pass) the contractual cash flow characteristics criterion as a result of this change?

Under the proposed SPPI test, there are many common features that will require the classification of a financial asset at fair value through net income in its entirety, irrespective of the probability that the feature will have an economic impact on the cash flows of the asset (other than features that are extremely rare of being triggered) or the materiality of the feature. A common example that demonstrates how the proposed SPPI guidance leads to counter-intuitive classification results is a residential mortgage loan with an interest rate that is fixed for the first 5 years, then resets to 1-month LIBOR on an annual basis until maturity. Under the existing model, the feature would not require bifurcation as it would not allow the investor to double its initial rate of return and double the then-market rate of return. Under the proposed guidance, this asset will fail the contractual cash flows characteristics criterion as it modifies the economic relationship between principal and interest. In our view, this interest rate reset feature does not significantly re-allocate cash flows between principal and interest and, therefore, should not result in the instrument failing the SPPI test. This is a plain-vanilla asset and the contracting parties have no intent on including hidden leverage in the instrument.

We find this conclusion troublesome and believe that the preclusion from amortized cost and fair value through other comprehensive income of a residential mortgage with this feature would detract from the decision usefulness of reported information. Over time with detailed analysis of common financial assets, we expect many similar examples will be discovered. To address these concerns, we suggest the following:

- When evaluating whether a contractual term of a financial asset introduces leverage that modifies the economic relationship between principal and interest, paragraph 825-10-55-17 would require an entity to determine whether such leverage is “more than insignificant.” Paragraph 825-10-55-18 states that if the modification to the economic relationship could result in cash flows that are “more than insignificantly different from the benchmark cash flows,” the financial asset does not meet the contractual cash flow

characteristics criterion in paragraph 825-10-25-17. We do not believe the application guidance provides sufficient examples and detail on how to determine whether a feature introduces “more than insignificant” leverage or variability that could be “more than insignificantly different from the cash flows of the benchmark instrument.” Thus, we expect inconsistent interpretations in practice. Consistent with our response to Question 7, we suggest that the cash flow characteristics assessment focus on whether cash flows are primarily payments of principal and interest. Irrespective of whether the Board decides to accept Alternative 2 in Question 4 or to retain the SPPI test in the proposal, we request that the Board remove the “more than insignificant” application guidance and replace it with clear examples and, if a qualitative assessment cannot be made under Alternative 2, a quantitative threshold for determining whether an interest rate feature causes a financial asset to fail the cash flow characteristics criterion. As a starting point, we suggest the Board consider the guidance in ASC 815-15-25-26 (the “double-double test”). If the Board believes that the double-double test is too broad, the Board may consider lowering the threshold (for example, to 1.5:1). Similar to our recommendation under Alternative 1 in Question 4, if the Board decides to include a quantitative threshold such as the double-double test, we suggest that the Board consider revising the guidance to require consideration of reasonably possible interest rate scenarios as opposed to all possible scenarios.

- ASC 825-10-55-24 states that “the entity must disregard the contingent term if it would affect the instrument’s contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal, and very unlikely to occur.” Our members believe this provision will likely lead to inconsistency in practice given the ambiguity involved in determining “extremely rare, highly abnormal, and very unlikely.” We also believe this condition is far too restrictive. As discussed under Alternative 2, the qualitative assessment should consider the significance of the embedded feature to the hybrid instrument and also the likelihood of the feature to impact the cash flows. We suggest that the Board allow an entity to exercise professional judgment and take into account the probability that the feature will materially impact the expected cash flows.

#### Question 9

For beneficial interests in securitized financial assets, the proposed amendments would require an entity to look through to the underlying pool of instruments in determining whether the tranche contains payments of solely principal and interest. Do you agree with this look-through approach? If not, why? What would you propose instead?

ISDA does not agree with the look-through approach proposed by the Board. We do not believe it is operational, and in some cases may not be feasible (e.g., due to legal constraints), to look through to the individual assets collateralizing a secured beneficial interest. We recommend the Board incorporate a provision that requires an entity to evaluate the contractual terms of senior beneficial interests that are of a certain credit quality (e.g., rated AA or better as is commonly applied to determine whether a beneficial interest is within the scope of Subtopic 325-40, Investments—Other—Beneficial Interests in Securitized Financial Assets (formerly EITF 99-20)) under the cash flow characteristics criterion at the beneficial interest level, not by looking through to the individual assets in the underlying pool. All other secured beneficial interests could be measured at fair value through net income.

Question 10

Do the proposed amendments appropriately convey the principle associated with the business model assessment? If not, why? What would you propose instead?

Question 11

Do the proposed amendments provide sufficient application guidance and illustrations on how to distinguish among the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the proposed guidance provided to describe those business models? If not, why?

With the exception of permitted sales out of the amortized cost category, ISDA believes that the proposed amendments provide sufficient application guidance and illustrations on how to distinguish among the three business models.

*Application guidance on amortized cost category*

The business model for instruments managed solely to collect contractual cash flows is currently defined in a very narrow manner, mostly due to the guidance around permissible sales activity. The proposed amendments represent a significant change from the held-for-investment loan model in current U.S. GAAP, which offers more flexibility with respect to sales than the held-to-maturity security model in Topic 320, Investments—Debt and Equity Securities. As proposed, we believe various instruments that form part of a bank’s core customer lending activity will be required to be measured at fair value through other comprehensive income even though amortized cost provides the most useful information for such assets. We do not believe this was the Board’s intent. To address this concern, we recommend that the guidance around permissible sales out of the amortized cost category be broadened to include additional examples of permissible sales and illustrations around unacceptable sales.

The proposed amendments permit sales out of the amortized cost category when the credit quality of a financial asset has suffered significant deterioration or in very infrequent other circumstances, consistent with the held-to-maturity guidance in Topic 320. However, sales may occur for reasons other than significant credit deterioration of the issuer and still be consistent with an entity’s documented hold-to-collect investment and risk policy. For example, sales may be due to entity limits set on exposure to a particular country/jurisdiction, industry or obligor, and may be summarized as sales due to concentration risk. Entity limits are necessarily fluid as economic conditions change – for example, limits to Eurozone exposure changed throughout the financial crisis, even though particular obligors did not suffer significant credit deterioration. Although these sales occur in response to concentration limits, they are also in line with a documented hold-to-collect investment strategy, which is different from sales made under a business model where assets are managed to be held or sold. ISDA recommends that the explicit prohibition on sales due to concentration risk in paragraph 825-10-55-31 be removed, and the application guidance be revised to clarify that sales due to concentration risk can be consistent with a business model whose objective is to hold assets in order to collect contractual cash flows.

While we think that the Board should make the clarification suggested in the previous paragraph, we do not believe sales due to concentration risk is the only example of an additional “acceptable” sale out of the amortized cost category nor do we believe it would be possible to develop an exhaustive list of acceptable reasons for sales. In our view, the guidance would be more useful and practicable if the Board also developed illustrations around *unacceptable* sales out of the amortized cost category. These illustrations should focus on sales that are inconsistent with a business model to collect contractual cash flows, for example, gains trading, duration



management (that is, managing on a fair value basis), and similar activities that are inconsistent with the hold-to-collect model.

We agree with the Board that a combination of factors rather than a single factor, should determine an entity's business model and thus an asset's classification. Although that is explicitly stated in paragraph 825-10-55-28, the guidance on sales out of the amortized cost category seems to override this principle with the result that sales are the strongest (practically the sole) factor to consider.

#### *Pools of similar financial assets*

We support the guidance in paragraph 825-10-25-30 on the application of the business model assessment to pools of similar financial assets when an entity expects to hold a portion of the pool to collect contractual cash flows and manage another portion to hold or sell. However, we request that the Board clarify how this guidance would be applied to pools of similar financial assets that are recognized over a period of time. For example, financial institutions often warehouse pools of financial assets and build those pools over time. We are unclear whether the pool should be allocated across the relevant categories based on daily batch processing or some other method such that the ultimate allocation was in line with management's intent with respect to each portion of the overall pool. Paragraph 825-10-25-30, which reads, "Upon initial recognition of a pool of similar financial assets...", implies that the entire pool must be initially recognized at the same time. We do not believe this was the Board's intent and suggest that the Board clarify that this guidance may be applied to pools of similar financial instruments that are established over time.

We also suggest that the Board provide guidance on the subsequent accounting for the financial assets accounted for under this allocation guidance. Inevitably, some individual assets initially classified in the amortized cost category will be sold and other individual assets initially classified either as fair value through other comprehensive income or fair value through net income will be identified as held-to-collect. For assets initially classified as fair value through other comprehensive income later identified as held-to-collect, we suggest that an entity be required to reclassify the asset to amortized cost by reversing the balance in accumulated other comprehensive income to bring the asset to par. Alternatively, the Board could require subsequent accounting similar to the guidance in paragraph 825-10-35-10(d) on reclassifications from the available-for-sale category and to the held-to-maturity category in current U.S. GAAP.

We also suggest that the Board consider expanding the allocation guidance in paragraph 825-10-25-30 to individual financial assets, for example, loan participations or syndications. Current U.S. GAAP permits an entity to classify a percentage of a single loan as held-for-sale and another portion as held-for-investment. We believe this guidance is reasonable and is consistent with industry practice.

#### *Hedging interest rate risk*

In addition, ISDA believes the amendments in paragraph 815-20-25-43 (from the FASB's Proposed ASU *Financial Instruments—Overall (Subtopic 820-10): Recognition and Measurement of Financial Assets and Financial Liabilities: Proposed Amendments to the FASB Accounting Standards Codification*<sup>®</sup>) may unnecessarily limit eligible hedge items. Under current U.S. GAAP, held-for-investment loans are eligible for fair value and cash flow interest rate hedges, whereas held-to-maturity debt securities are not. Our members believe that an institution can be subject to interest rate risk in its net interest margin, irrespective of the business model or the anticipated selling activity. For example, many financial institutions finance fixed-rate financial assets with floating-rate debt. Those institutions often manage their exposure to interest



rate risk associated with the floating-rate debt or with their future net interest margin through fair value hedges of the fixed-rate financial assets, either in the aggregate or at a portfolio level. Thus, we strongly encourage the Board permit interest rate hedging strategies for all financial assets measured at amortized cost, including debt securities.

**Question 15**

The proposed amendments would eliminate the unconditional fair value option (for financial instruments within the scope of this proposed guidance) in existing U.S. GAAP and, instead, permit an entity to elect to measure at fair value, with all changes in fair value recognized in net income, all of the following:

- a. A group of financial assets and financial liabilities if the entity both:
  1. Manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis
  2. Provides information on that basis to the reporting entity's management.
- b. Hybrid financial liabilities that meet certain prescribed criteria.
- c. Financial assets that meet the contractual cash flow characteristics criterion and are managed within a business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets (in accordance with paragraph 825-10-25-25(b)).

Do these options provide decision-useful information? If not, why?

As proposed, we do not believe these options provide decision-useful information. Please see our detailed comments on the following topics: unconditional fair value option, managed on a net basis, hybrid liabilities, equity method investments, and the fair value option when economically hedging credit risk (IFRS 9).

*Unconditional Fair Value Option*

ISDA strongly supports the ability of a reporting entity to unconditionally elect the fair value option for financial assets and liabilities. The unconditional election allows for external reporting that is consistent with the management outlook for the financial asset or liability and reduces the instances where a mixed measurement model creates potentially misleading volatility in earnings. The FASB should retain today's fair value option on the basis of the following:

- The Board acknowledges in paragraph BC322 that the recognition and measurement model in the proposed Update will not result in fair-value-through-net-income classification for many items currently subject to fair value election. As such, the fair value option remains an important part of reducing the volatility associated with a mixed measurement model. While the FASB's objectives include reducing volatility associated with a mixed measurement model, we believe the FASB's proposed approach to fair value election introduces unnecessary complexity in application by trying to anticipate situations where the mixed measurement model most commonly has an impact and either precludes election for common sources of mixed measurement volatility (e.g. financial liabilities with non-bifurcatable risks hedged using derivatives and where hedge accounting is not otherwise available) or is otherwise unclear on whether common fact patterns would be eligible for fair value election under the proposed Update (see further discussion below). Consequently, the proposed Update will result in reporting entities experiencing the sort of earnings volatility the unconditional fair value election was originally intended to alleviate and which the FASB seeks to mitigate based on paragraph BC322.

- One of the most challenging aspects of the accounting for financial instruments under a mixed measurement model relates to the question of scope and determining which recognition and measurement principles apply to a specific financial instrument. This is particularly the case for entities with subsidiaries that apply industry-specific accounting guidelines in the AICPA Audit and Accounting Guides, *Depository and Lending Institutions, Brokers and Dealers in Securities*, and *Audits of Investment Companies*. The unconditional fair value election eliminates unnecessary complexity in applying U.S. GAAP by eliminating the need for scope assessment and thus potential differences in application across reporting entities.
- We also do not agree with the FASB's perception that the benefits of today's unconditional fair value election are less than the costs of reduced comparability among reporting companies. Comparability among reporting companies is reduced by varying business models and hedging programs rather than the potential use of a fair value election. Any incremental reduction in comparability due to an unconditional fair value election is far outweighed by the benefits of reducing complexity in U.S. GAAP and alleviating earnings distortion associated with a mixed measurement model.

If the FASB moves forward with limiting the unconditional fair value option, we propose that the option be limited in a manner equivalent to IFRS 9, permitting fair value election when doing so eliminates or significantly reduces a measurement or recognition inconsistency (i.e., an accounting mismatch). The IFRS 9 approach accomplishes the FASB's objective as stated in paragraph BC322, converges with International Financial Reporting Standards, and does not introduce unnecessary complexity.

#### *Managed on a net basis*

As currently drafted, the proposed Update permits fair value election of a group of financial assets and financial liabilities when an entity manages the exposure relating to the financial assets and financial liabilities (which may be derivative instruments subject to Topic 815, Derivatives and Hedging) on a net basis. Paragraph BC322 indicates that the FASB intends for the aforementioned requirement to allow fair value election to alleviate an accounting mismatch without having to apply complex hedge accounting provisions. Per the discussion in the Basis for Conclusions, it appears the FASB's intent is to allow election for positions which are economically offsetting and managed collectively on a fair value basis (whether or not they result in recognized assets and/or liabilities). On the basis of these examples, we recommend that if the FASB retains the "net basis" requirement, it should permit election for *economically offsetting exposures which are managed on a fair value basis*.

- Many financial institutions manage the credit risk associated with a loan by executing a single-name credit default swap (CDS) indexed to the borrower. It is not clear whether this common fact pattern, which appears to meet the spirit of the requirement per paragraph BC322, would be considered a "group of financial assets and financial liabilities" whose exposure is managed on a net basis. While the loan is an asset for the reporting company, the CDS is purchased protection which may not be presented as a liability on the balance sheet. Thus, it is not clear whether this would be considered a "group of financial assets and financial liabilities" under the election requirement. It would also be counterintuitive that fair value election would be possible were the purchased credit protection to be in a liability position, but not in an asset position. Purchased credit default swaps can be either assets or liabilities depending on the direction of changes in credit spreads of the referenced entity.

- We understand the proposed Update precludes election for hybrid liabilities with embedded features that clearly do not require bifurcation and separate accounting (see related discussion below requesting confirmation that our understanding is accurate). A common example of a hybrid liability which does not require bifurcation is a debt instrument with a range-accrual feature. This type of feature typically does not fail the double-double test and thus the fair value option could not be elected under the hybrid liability provisions of the proposed Update. These instruments are commonly managed by the issuer on a fair value basis and often economically hedged with interest rate swaps or other cash instruments that are held for trading purposes. These economic hedges provide offsetting exposure to the issued liability but may or may not result in a recognized asset, depending on market conditions. Thus, it is not clear whether this would be considered a “group of financial assets and financial liabilities” under the election requirement. In order to achieve consistent and useful results, the final guidance should clarify that these hybrid liabilities and the related interest rate swap (or other cash instrument) meet the definition of a group of financial assets and financial liabilities that are eligible for the election. This approach would be consistent with how an entity manages structured notes regardless of the specific embedded risk type (i.e., equity-linked notes versus notes with structured interest-linked features). This interpretation also yields the most meaningful results for presentation of changes in own-credit risk in other comprehensive income for hybrid liabilities managed on a net fair value basis, irrespective of whether bifurcation would be required.
- Many financial institutions hold prepayable fixed-rate, AAA-rated, agency-issued, mortgage-backed securities (or a pool of prepayable residential mortgages) which are economically hedged by interest rate swaps. These securities often do not qualify for hedge accounting because the prepayment risk associated with the underlying pool of loans is not fully offset by a cancellable interest rate swap and the resulting levels of ineffectiveness may preclude hedge accounting. Because the relationship does not qualify for hedge accounting, entities often make a fair value election on the securities to align their measurement with the interest rate swaps that economically hedge them. The proposed Update indicates that this sort of security would not be classified at fair value through net income on the basis of its cash flow characteristics. Thus, correcting an accounting mismatch for this type of transaction and related risk management is possible only through a fair value election and it is not clear whether the securities and their economic hedges would be considered a “group of financial assets and financial liabilities” under the election requirement. Therefore, we believe the final guidance should clarify that debt instruments and derivative instruments that are in an economic hedging relationship (i.e., the net exposure is managed on a fair value basis) meet the definition of a “group of financial assets and financial liabilities” under the election requirement.

#### *Hybrid Liabilities*

ISDA requests that the FASB clarify the fair value election requirement for hybrid liabilities. As drafted, it is not clear whether the election may be applied only to those liabilities containing a feature which requires bifurcation or whether it may be applied to a broader set of liabilities that contain embedded features that do not require bifurcation but may “significantly” alter the cash flows of the instrument. Paragraph BC324 appears to indicate that the election applies only to instruments containing a bifurcatable feature: “The Board decided that providing a fair value option in that situation would achieve an appropriate balance between avoiding the cost of bifurcating a hybrid financial liability and limiting the fair value option to situations in which an option is necessary to reduce implementation costs.” However, the election requirements in



paragraph 825-30-15-3 imply a broader set of liabilities could be eligible. We support this view. Accordingly, we request that the FASB clarify the election requirement for hybrid liabilities includes this broader population.

#### *Equity Method Investments*

We believe that equity-method investments should be eligible for fair value election and, contrary to the Board's belief presented in paragraph BC26, we do not believe that equity-method accounting is always more "appropriate" for these investments. Rather, in some instances, fair value measurement best represents the management strategy for an investment. Further, the conditions for held-for-sale treatment may not always be satisfied. There is a significant cost to applying equity method accounting to these investments, particularly when they are held by businesses that manage their investments on a fair value basis and have built reporting infrastructure with fair value measurement and reporting in mind. We believe the fair value election for equity-method investments accommodates differences in management outlook and allows reporting companies to balance the costs associated with application of equity-method accounting with their related business strategy.

#### *Fair value option when economically hedging credit risk (IFRS 9)*

Under the revised IFRS 9, entities will be permitted to elect the fair value option for a financial instrument *after* initial recognition, if the credit risk of the financial instrument (for example, a loan or loan commitment) is subsequently risk managed with a credit derivative. In order to qualify for fair value accounting for the financial instrument, IFRS 9 appropriately requires that the following criteria be met: (a) the name of the credit exposure (for example, the borrower) matches the reference entity of the credit derivative, and (b) the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative. ISDA's members strongly recommend that the FASB incorporate the same guidance into its final standard on recognition and measurement, for the reasons discussed below.

Under current U.S. GAAP (Topic 825), entities may elect the fair value option only at initial recognition of a financial instrument, or in certain specified other circumstances. For financial institutions with significant portfolios of loans and loan commitments, it is not possible to identify at initial recognition the specific loans (or portions of loans) that will be risk managed with credit derivatives. Reasons for this include:

- Creditworthiness of particular borrowers changes over time. For example, a financial institution could have a policy to risk manage exposures with purchased credit derivatives if the borrower's internal or external credit rating declines to a certain level, or declines by a certain number of ratings categories. The financial institution would decide not to purchase credit protection on a particular borrower rated for example A at inception of a loan, but if the borrower's credit rating declined to BB+ the financial institution would look to manage any subsequent changes in credit risk with credit derivatives;
- Financial institutions establish risk limits for particular borrowers that change over time, based not only on the creditworthiness of the specific borrower, but on country/jurisdiction, industry, and other factors;
- Total exposures to a particular borrower change over time, and include loans, debt securities, derivatives, clearing arrangements, and various other transactions. The financial institution may decide to purchase credit protection to manage its total risk exposure, as opposed to selling loans or debt securities or reducing/terminating other business arrangements; and



- The pricing and availability of credit derivatives change over time. For example, credit derivatives are not available for many counterparties until their total outstanding debt reaches a certain level, or until the counterparty supplements bank financing with bonds issued to the capital markets. This evolution is common for borrowers in emerging markets.

ISDA's members believe that a fair value election after initial recognition, when the entity is managing the risk exposure of a financial instrument with credit derivatives, results in better information for financial statement users. While the entity holds both the financial instrument and the related credit derivative, fair value accounting for both instruments that reflects the extent of offsetting changes in fair value is appropriate. Any changes in fair value of the underlying financial instrument since initial recognition would be immediately recognized in net income, and ISDA's members would support highlighting such amounts in either a separate caption on the income statement or in the footnotes to the financial statements.

Question 16

Should financial liabilities subsequently be measured at amortized cost, unless certain exceptions are met? If not, why?

We generally agree that financial liabilities should be recognized at amortized cost. However, we believe an entity should have the option to unconditionally elect to measure a financial liability at fair value through net income or, at a minimum, in order to eliminate an accounting mismatch. Please see our specific comments on the fair value option in Question 15.

Question 19

The proposed amendments would provide a practicability exception for measuring equity investments without readily determinable fair values that do not qualify for the practical expedient in paragraph 820-10-35-59 (that is, the net asset value per share expedient) and a one-step impairment model for all equity investments subject to the practicability exception. Do you agree with the proposed amendments? If not, why?

ISDA requests that the Board clarify the guidance in paragraph 825-10-35-17 to "... measure an equity investment without a readily determinable fair value ... at its cost minus impairment, if any, plus or minus changes resulting from observable price changes..." Because a downward price change is often evidence supporting an impairment loss, the proposed guidance in paragraph 825-10-35-17 may be misinterpreted to require double-counting in circumstances where there is both a downward price change and a recognized impairment. For example, if an equity investment initially recorded at a cost of \$100 was subject to an observable downward price change of \$15 that resulted in an impairment loss of \$15, it seems the guidance in paragraph 825-10-35-17 may mislead an entity to record the investment at \$70 (at its cost of \$100, minus impairment of \$15, minus the downward observable price changes of \$15). Clearly, we do not believe this was the Board's intent. We believe the impact of impairment and any downward price change should not be additive and that the carrying value of the investment in this example should be \$85, rather than \$70. We suggest that the Board make the following edits to address this point: "... measure an equity investment without a readily determinable fair value ... at its cost minus impairment, if any, plus or minus any incremental changes resulting from observable prices changes that were not recognized as impairment..."

## Question 21

Under the amendments in this proposed Update, hybrid financial assets would not be required to be analyzed for bifurcation under Subtopic 815-15 and would be assessed in their entirety on the basis of the proposed classification requirements. In contrast, hybrid financial liabilities would be assessed for bifurcation and separate accounting under Subtopic 815-15, and the financial liability host contract would be subject to the proposed amendments. Do you agree with this proposal? If not, why? What would you propose instead?

ISDA disagrees with the asymmetry in the proposed accounting model. As stated in our response to Question 4 above, ISDA supports the ability to separate an embedded derivative from a non-derivative host contract, whether that host contract is a financial asset or a financial liability. We believe that if an entity intends to hold an asset to maturity to collect contractual cash flows, a more decision useful measurement attribute would be amortized cost with the embedded derivative being separately accounted for at fair value through net income consistent with the existing model in Topic 815. The proposed guidance would result in more hybrid financial assets measured at fair value through net income whereas related hybrid financial liabilities would merely have the embedded features bifurcated and measured at fair value.

## Question 23

The proposed amendments would require public entities to parenthetically present fair value for items measured at amortized cost on the face of the statement of financial position. Does that presentation requirement provide decision-useful information? If not, why? What would you propose instead?

ISDA does not believe that this presentation requirement provides decision-useful information for investors. We believe that the financial statements should reflect the primary measurement attribute for financial instruments. Presenting both fair value and amortized cost information on the face of the statement of financial position may confuse users of financial statements and adds unnecessary clutter to the face of the statement of financial position. Therefore, we believe fair value information for amortized cost financial instruments should continue to be disclosed in the notes rather than on the face of the financial statements.

With respect to the requirement to present amortized cost information for issued debt that is measured at fair value, we fail to understand the usefulness of this information. It would be operationally challenging to compute the amortized cost basis for these financial liabilities (e.g., structured notes) as the embedded feature would complicate the effective interest calculation. This amount is not relevant, would be costly to prepare, and provides no added benefit to users.

## Question 25

The proposed amendments would require an entity to separately present changes in fair value attributable to changes in instrument-specific credit risk in other comprehensive income for financial liabilities for which that entity has elected the fair value option. Would the proposed presentation requirement provide decision-useful information? If not, why? What would you propose instead?

ISDA strongly agrees with the proposed requirement to separately present in other comprehensive income the change in fair value attributed to the issuer's own credit for financial liabilities for which that entity has elected the fair value option. We agree with the Board's assessment in BC291 that these amounts are generally not realizable. Further, we note that these amounts are often excluded by financial institutions in their non-U.S. GAAP earnings metrics, by investors in



their analysis of those institutions, and under the Basel III requirements for calculating Tier 1 capital. Therefore, we believe that the proposed amendments improve financial reporting.

Additionally, we believe that the term “instrument-specific credit risk” may confuse some readers of the final guidance and suggest that the Board use the term “reporting entity’s own credit risk,” consistent with paragraph 820-10-35-17.

**Question 26**

The proposed amendments would require an entity to separately recognize in net income changes in fair value attributable to foreign currency gain or loss on foreign-currency-denominated debt securities measured at fair value through other comprehensive income (see paragraphs 825-10-45-14 through 45-15). Is the proposed fair-value-based method provided for computing the foreign currency gain or loss component operable? If not, why? What would you propose instead?

ISDA supports the proposal to require separate recognition in net income of the foreign currency gain or loss on foreign-currency-denominated debt securities measured at fair value through other comprehensive income. The proposed amendments in paragraphs 825-10-45-14 through 45-15 would require calculation of foreign currency gains or losses using a fair-value-based method for financial instruments measured at fair value through other comprehensive income. In contrast, IFRS requires a cost-based calculation method. Under current U.S. GAAP, investment companies use a cost-based method (paragraph 946-830-45-17). We do not believe either calculation method to be conceptually superior and, therefore, request that FASB permit either method as a policy election.

**Question 29**

Do you agree with the proposed disclosure requirements? If not, which disclosure requirement would you change and why?

*Disclosures about sales of financial assets measured at fair value through other comprehensive income*

Some of our members believe that the proposed disclosure within paragraph 825-10-50-37 may be operationally difficult to implement in certain circumstances. According to the requirement, in a period that includes the sale of an asset held at fair value through other comprehensive income, the realized gain or loss associated with that sale that has been recognized in net income should be disclosed. However, the requirement in subparagraph 50-37(b) is to disclose “the amount of net unrealized holding gain or loss [associated with the sale] ... that previously had been recognized in accumulated other comprehensive income [AOCI].” To satisfy this requirement for an asset sold, it seems necessary to distinguish between the unrealized gain/loss that was previously recognized in AOCI, and the unrealized gain/loss recognized in the current period.

Although this distinction would be straightforward for sales of many assets held during a prior period and sold during a current period, it can be more complex to systematically distinguish these amounts in circumstances where multiple purchases and sales of the same asset have occurred for the reporting entity during the same time period. It is unclear whether the benefit of this disclosure is justified by the cost that may be required to provide it.

*Disclosures about fair value information for financial assets measured at amortized cost*

The proposed fair value disclosure requirements in paragraph 825-10-50-34 for financial instruments that are measured at amortized cost will not provide decision-useful information or incremental insight into the financial position and operating results of a reporting entity.



Fair value disclosures provide insight into the valuation techniques and the relative reliability of the inputs used to value financial instruments. However, this information will only be meaningful for financial instruments where the fair value may actually be realized through a sale or termination of the instrument prior to contractual maturity. Under the proposed requirements, when financial instruments will be held and managed within a business model that has the objective of holding the instruments to collect the contractual cash flows, information about valuation processes and quantitative information about the unobservable inputs used in the fair value measurement will not be relevant. Given the limited population and plain nature of the assets and liabilities that are expected to qualify for measurement at amortized cost, and further because realization of the fair value of such financial instruments will be inconsistent with the business model under which they will be held, it is unclear what benefit or insight will be gained by financial statement users through the disclosure of quantitative information about unobservable inputs or valuation policies and procedures around the fair value of items that are not measured at fair value on the balance sheet.

In the current environment, fair value information is not significantly utilized in making decisions and evaluating the financial performance of instruments measured at amortized cost. Rather, it is largely calculated only for purposes of required financial statement disclosures. We are not aware of any inquiries by analysts, investors or others with respect to fair value information beyond the current disclosures regarding assets and liabilities that are measured at amortized cost. Accordingly, we believe that the current level of fair value disclosure is sufficient and appropriate for assets and liabilities measured at amortized cost.

Question 30

Should an entity be permitted to early adopt only the proposed presentation requirements related to changes in instrument-specific credit risk for hybrid financial liabilities that would qualify for the fair value option under the proposed requirements? If not, why?

We strongly support the Board's decision to permit early adoption of these amendments upon issuance of a final standard.

Question 32

How much time is needed to implement the proposed guidance?

The changes to the classification and measurement model, as proposed, would be substantial and would require enhancements to policies, procedures, and systems, as well as significant detailed research regarding all terms in financial assets and how they would be assessed under the SPPI test. In order to implement the requirements, ISDA believes the effective date should be no sooner than three years from the release of the final guidance.

Question 37

The proposed amendments would eliminate the fair value option for hybrid nonfinancial instruments in current U.S. GAAP and would provide a new fair value option for hybrid nonfinancial liabilities. For a hybrid nonfinancial liability, an entity would apply the bifurcation and separate accounting requirements in Subtopic 815-15 and account for the embedded derivative in accordance with Topic 815. The financial liability host that results from separation of the nonfinancial embedded derivative would be subject to the proposed amendments. However, an entity would be permitted to initially and subsequently measure the entire hybrid nonfinancial liability at fair value (with changes in fair value recognized in net income) if after applying Subtopic 815-15 the entity determines that an embedded derivative that requires bifurcation and separate accounting exists. In contrast, for a hybrid nonfinancial asset the proposed amendments would require the hybrid contract to be measured at fair value (with changes in fair value recognized in net income) if the hybrid nonfinancial asset contains an embedded derivative that would have required bifurcation and separate accounting under Subtopic 815-15. Do you agree with the proposed amendments? If not, why? What would you propose instead?

As discussed above, we believe that the ability to elect the fair value option should be unconditional for assets and liabilities. Carrying an asset or liability at fair value is elected commonly when there is a measurement mismatch between assets and liabilities, and prohibiting an entity from presenting assets and liabilities on the same measurement basis will lead to information that is not decision-useful.