

# JPMORGAN CHASE & CO.

Bret Dooley  
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May 15, 2013

Ms. Susan M. Cospers  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

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

Dear Ms. Cospers:

JPMorgan Chase & Co. appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB" or the "Board") proposed Accounting Standards Update *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* ("Exposure Draft", or "ED"). We not only prepare our own financial statements, but are also a significant user of other entities' financial statements, through our lending and market making relationships with thousands of corporate clients, and investment and asset management activities. Our comments reflect our views from both perspectives.

We support the Board's efforts to reduce the complexity in accounting for financial instruments and to develop a consistent, converged framework for classifying these instruments. We support a model that aligns loans and securities in a three category framework, and believe that this alone would represent a significant simplification compared to current practice. However, there are many aspects of the Exposure Draft that would create new and additional interpretive and operational complexity, and therefore we believe that the Exposure Draft does not achieve the Board's stated objectives and does not represent a substantial improvement to current practice that would justify the significant costs of implementation.

Instead, we believe that the Board's objectives can be obtained at lower cost by more targeted amendments to current US GAAP. Below, we summarize those targeted amendments and our primary concerns with the Exposure Draft. The Appendix provides the Firm's responses to the FASB's relevant Questions for Respondents.

## *Summary Comments*

- We agree that current US GAAP can be simplified into the three classification and measurement categories for debt instruments proposed by the ED. Aligning the accounting for loans and securities, with consistent definitions of the three categories would represent a substantial simplification of current practice.

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However, the restrictions placed on the circumstances in which a company can sell debt instruments held at amortized cost without calling into question its business model do not reflect common risk management practices. The Board already recognized in the ED that sales due to deterioration in a borrower's credit standing is consistent with the concept of investing for the collection of cash flows, and we believe that broader credit risk management strategies are also consistent with that concept. For example, in typical loan portfolios held for the collection of cash flows, concentration risk is a key risk that is monitored against limits and managed. Sales as a result of increases in concentration risk, or increased sensitivities to concentration risk in certain products, geographies or customer segments is a common risk management tool to limit adverse impacts due to a heightened risk of credit deterioration that may not be visible yet in credit risk statistics. Similarly, given regulatory and market constraints on balance sheet size and capital, a fundamental business consideration is the allocation of credit risk capital to certain customer and product segments. As the risk/return relationship changes for certain segments, it is necessary to retrench certain activities to make room for serving different customer segments. Such refinements of the portfolio mix are a necessary element of sound credit risk management of a retained loan portfolio and should be permitted within the amortized cost category.

Sales activities within the amortized cost category should resemble those existing today for held for investment loans rather than those for held to maturity securities. Sales could be reasonably restricted through an assertion at inception that the entity intends to hold the financial asset for the foreseeable future, and that sales out of amortized cost should be caused by a valid business purpose other than recognition of a gain or loss.

The "solely payments of principal and interest" (SPPI) test is not an appropriate starting point for a cash flow characteristics test and would introduce a significant amount of interpretive and operational complexity that we believe is not warranted. While the intent of the SPPI test – to create a broad principle to use in identifying instruments that should be measured at fair value through earnings – is a worthy objective, preliminary analysis of it has already identified a number of plain vanilla financial assets (including many adjustable rate mortgages and home equity lines of credit and agency mortgage backed securities purchased at a discount) that would need to be classified at fair value through net income. We believe that addressing these circumstances (and others that are almost certain to be identified) will require significant interpretive guidance from the Board and will ultimately be no less complex than the clearly and closely related tests under current US GAAP. Also, the introduction of a new model for financial assets while retaining the old model for financial liabilities is clearly not a simplification, but the addition of complexity.

One concern about the SPPI test is that because it applies to the general classification of an instrument, any error in applying the test may have a financial statement effect that is not related to the actual error. Under current US GAAP, if a bifurcated embedded derivative feature is identified subsequent to purchase, the value of the embedded derivative feature missed in the initial analysis is often not significant. However, under the ED, such a feature could require the entire instrument to be marked to fair value through earnings – and the change in fair value of the instrument may be driven by components that are entirely unrelated to the characteristic that failed the SPPI test.

The current bifurcation rules should be retained, and clearly and closely related guidance could be simplified based on preparer feedback and to address any concerns of the FASB regarding current interpretive practice.

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- Please see our additional recommendations related to the fair value option, equity securities, and disclosures in the responses to the Questions for Respondents, attached.

We appreciate the opportunity to submit our views. We would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact me at 212.648.0404 or Laurin Smith at 212-648-0909.

Sincerely yours,

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

Bret Dooley

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## Appendix – Responses to Questions for Respondents

The below responses are grouped by topic where applicable.

### Scope

**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?

We generally agree with the scope of financial instruments included in the ED. However, regarding item (k), the definition of “an acquisition-related contract” is unclear, as we could not find this term defined in any existing literature. The Board should clarify what is meant by this “acquisition-related contract” scope exception and whether it is limited to business combinations within Topic 805. The Board should further clarify whether it intends to exclude from the scope of the ED “contingent consideration arrangements” in the scope of Topic 805 as well as “contingent consideration arrangements related to other asset acquisitions” or perhaps “all contingent consideration arrangements”, or whether the FASB has some other intended meaning. We note that paragraph BC42 of the ED indicates that the Board intended to scope out all contingent consideration arrangements, but item (k) in paragraph 825-10-15-8 scopes out only those contingent consideration arrangements within the scope of Topic 805.

**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 industry-specific specialized guidance scope exceptions and believe that such specialized guidance should be retained, as it provides the most useful representation of those industry-specific activities. In addition, the FASB may wish to consider taking the opportunity to review the specialized guidance to determine where such guidance may be more broadly applied and reduce the need for industry specific-guidance.

### Recognition – Cash Flow Characteristics

**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?

We agree that the classification of financial assets should consider the contractual cash flow characteristics of the instrument. However, the proposed amendments are not sufficiently clear to determine the application across financial assets, and would likely not be interpreted consistently in practice. In addition, we believe that the proposed amendments would likely result in many common, plain vanilla debt instruments failing to qualify for amortized cost or FV-OCI even though the business model for those instruments would not have the characteristics that qualify for trading under current US GAAP. These results for common financial instruments were not discussed by the Board in its deliberations and may represent unintended consequences.

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While we understand the desire for convergence with IFRS with respect to the cash flow characteristics test, the SPPI principle is not an improvement over the clearly and closely related principle in current US GAAP and IAS 39. We acknowledge that the amount of guidance existing for the clearly and closely related principle is extensive. However there is very little interpretive complexity remaining in practice; preparers and auditors know how to apply the guidance consistently across a wide variety of products. It does not appear that the same clarity could be gained over time for the SPPI test without a similar volume of additional implementation guidance. Therefore we question the benefit of discarding one cash flow characteristics principle for another, given that the cost will be so high, and that such interpretive work would need to be conducted in the same timeframe as implementing other significant changes to the accounting for financial instruments.

One simple example of the complexity and potentially counterintuitive result of applying the SPPI test to common financial assets relates to credit card reward programs. Under the terms of credit card agreements with borrowers/cardholders, credit card issuers may grant cardholders reward points when they use their credit cards to purchase goods and services from merchants. Cardholders can then typically redeem those points for cash (payable by the credit card issuer), merchandise or services (e.g., travel). The credit card issuer contracts with third-parties to fulfill orders placed by cardholders who elect to redeem their points for merchandise or services.

When the terms of a credit card rewards program are an integral part of the credit agreement with the cardholder, any rewards earned by the cardholder are not technically payments (or reductions of) principal or interest on the principal amount outstanding. Therefore, any underlying credit card loans may not satisfy the contractual cash flow characteristics criteria set forth in 825-10-25-17, and such loans may be required to be accounted for at fair value with changes in fair value recognized in net income.

Although typically documented as part of the credit agreement with the cardholder, absent the proposed SPPI guidance, the Firm would consider these rewards program to be within the scope of the Board's "Revenue Recognition" guidance. Under this model, we would consider the credit card rewards program to be a separate arrangement with the cardholder that is economically unrelated to the lending arrangement. In other words, the credit agreement with the cardholder includes both: (i) a lending arrangement, and (ii) a volume discount incentive tied to the use of the credit card. If credit card rewards programs are determined not to satisfy the requirements of 825-10-25-17, this may suggest that any rebate or volume discount arrangement with any commercial customer may cause any related trade receivable from that customer to be classified and measured in accordance with 825-10-35-9 (fair value through net income). While we presume that the Board does not intend these outcomes, we believe that they would in fact result from the literal application of this proposed guidance.

If the Board prefers the SPPI principle because it prevents specific types of debt instruments from qualifying for amortized cost, this objective would be better achieved through targeted changes to existing guidance, which would be a far more efficient approach that would result in more understandable results. Such targeted changes could also achieve convergence in outcomes with IFRS at a much lower cost to preparers and auditors in the US than wholesale replacement of the existing model.

If the Board prefers the SPPI principle because it believes that such a principle "reduces complexity", we disagree. Since the bifurcation model is retained for financial liabilities, the existing rules-based

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complexity will not be eliminated. Furthermore, introducing a different model for assets as compared to liabilities only increases the complexity, especially if that model results in significant interpretive questions and measurement outcomes that seem inappropriate, which we believe would be the case.

The replacement of a bifurcation framework with one that requires classification of the entire instrument also introduces significantly greater consequences for an error than the current model. Under current US GAAP, if the analysis of a single term is incorrect, the financial reporting consequence of a failure to identify a bifurcable derivative is measured by the cumulative change in fair value of the embedded derivative. Many derivative features requiring bifurcation relate to remote contingencies and thus have very little economic value. Under the proposed model, an incorrect analysis of a single embedded feature would be measured as the total cumulative change in value of the instrument, including changes in value that are completely unrelated to the embedded derivative (for example, due to changes in market interest rates). We believe that these circumstances, where the identification of a relatively minor issue has a comparatively large financial statement effect, have proven problematic in practice (for example, experience in the United States with the application of the "short cut" hedge effectiveness test for hedge accounting). For this reason alone, we urge the FASB to consider whether the bifurcation model should be retained in order to better align the financial reporting consequences with the magnitude of the embedded feature's significance.

If the Board decides to proceed with its replacement of the bifurcation model, key elements of the SPPI test remain to be clarified. For example, various parts of the application guidance are unclear, including:

- The types of features that fall under the modified economic relationship guidance versus other guidance
- The guidance that the probability of occurrence must not be considered appears to conflict with the guidance on disregarding events that are extremely rare, given that "rare" is by definition a probability
- The prepayment guidance, together with the definition of principal, inappropriately seems to result in FV-NI classification for pre-payable assets purchased at a discount or premium
- Please see the response to Question 9 for our significant concerns with the beneficial interest guidance in the ED.

**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?

The definition of principal as something other than the face value of the debt instrument will cause certain common debt instruments to fail the contractual cash flow characteristics test. For example, simple agency mortgage-backed securities and callable debt and other common debt investments may fail the test if purchased at a discount substantial enough to be deemed more than "reasonable additional compensation for the early termination of the contract". For agency mortgage backed securities, this outcome would be counter to the conclusion the Board reached a short time ago in DIG B40 [ASC 815-15-25], which states that a securitized interest in prepayable financial assets would not be subject to bifurcation if certain criteria are met. If the Board does not decide to maintain a modified

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bifurcation principle, we believe that the definition of principal should be expanded to include repayment of the principal amount at maturity or “face value”.

Furthermore, we suggest that the Board include examples to illustrate what is intended by the inclusion of the words "or other settlement" in the proposed definition of principal. Without further guidance, it is not clear what the Board intends to include as principal, given that "or other settlement" could be interpreted in a very broad manner.

**Question 6:** Do the proposed amendments contain sufficient application guidance and illustrations on implementing the cash flow characteristics assessment? If not, why?

The application guidance in the ED is not sufficient for explaining the intended implementation of the cash flow characteristics assessment. Given the large number of different security types in the marketplace, the application guidance should seek to address a higher number of instruments. We believe that many of the examples in current GAAP should be addressed in the guidance, including certain of those found in SFAS 133 as amended by SFAS 155 and DIG C22, and those addressed in DIG B16 and DIG B40 [ASC 815-15-55-170 through 225; ASU 2010-11; ASC 815-15-55-13; ASC 815-15-55-141 through 159], given that those examples were driven by common questions on common instruments. In addition, the differences in outcomes of the clearly and closely related test and SPPI test should be explained and justified in the basis for conclusions. It is currently unclear how to apply the SPPI test to those examples, and whether any outcomes that differ from the outcomes of the clearly and closely related test were intended by the Board.

**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?

**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?

The modified economic relationship test as drafted could result in some of the most common loan receivables, such as adjustable rate mortgages (“ARMs”) and credit card loans that participate in reward programs (as discussed more fully under Question 4), to fail to qualify for amortized cost. In contrast, the clearly and closely related guidance has been tested for many years in practice, generally results in sensible measurement classifications, and uses as its benchmark instrument the “host” contract which typically actually exists in the marketplace, rather than a hypothetical financial asset as considered in 825-10-55-19.

If the Board chooses to keep the SPPI model rather than retain a modified version of current GAAP for financial assets, at a minimum, the benchmark instrument should be an actual instrument that is transacted in practice, and the ED should contemplate that the terms of the leading debt instruments traded in the market are by definition a repayment of principal and interest. The requirement to match the reset date of the instrument with the reset date of the index should also be removed. In the case of

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ARMs, lenders commonly base ARM interest rates on a variety of indexes including the Prime rate (which does not have an associated tenor) and the London Interbank Offered Rate (LIBOR). With most ARMs, the interest rate is reset periodically (every month, quarter, year, etc.) and the reset frequency of the ARM often does not match the reset frequency of the referenced index. However, there is no intent by the borrower or the lender to convey consideration for anything other than time value of money and credit risk.

**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?

We do not agree with the look-through approach proposed for securitized financial assets. We currently analyze securitized products under ASC 815-15-9 and ASU 2010-11 (formerly DIG Issue C22) and ASC 815-15-25-26 through 33 (formerly DIG Issue B40), which is a “look-through” approach to identify embedded credit and prepayable features that would require bifurcation. Current US GAAP requires an analysis of the beneficial interest’s contractual terms, which in itself requires an understanding of the assets, liabilities and other financial instruments within the securitization structure. However, the look-through approach proposed in the ED requires an analysis of not only the terms of the underlying assets, but also the purchase price of those assets to determine the principal amount. We believe the current GAAP requirements for analyzing embedded derivatives in beneficial interests identifies a great many of the features that would be intended to be captured in the SPPI test. We do not believe that the resource intensive requirement to identify the purchase price of the underlying assets and whether it meets the SPPI test, particularly for multi-layer structures like CDOs and CLOs, will result in a better accounting outcome than under the current accounting model. We propose that the FASB retain a bifurcation model for financial assets, as set out in our response to Question 4.

In addition, the look-through approach proposed in the ED requires a determination as to whether the underlying pool can be changed after recognition in a way that the beneficial interest may not meet the contractual cash flow characteristics test. We think a requirement to consider all hypothetical modifications to underlying assets is impractical and may result by default in many common debt instruments being classified in trading.

We do not agree with the credit risk criterion required in paragraph 825-10-55-26(c). It is unclear to us why this criterion is required for securitized products. An entity can purchase a credit-impaired whole loan and classify it as amortized cost; however, it is unclear why a beneficial interest of similar credit quality may only be eligible for FV-NI classification. If the FASB’s intent is to prohibit residual interests from qualifying for amortized cost accounting, we believe this can be achieved with additional guidance about residual interests without impacting the accounting for other tranches in the securitization structure. We propose the FASB remove this criterion or justify the difference in accounting treatment compared to other investments of similar credit quality.

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## **Business Model**

**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?

**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?

We agree that the classification of financial assets should consider the contractual cash flow characteristics of the instrument and the business model within which the financial assets are managed, and we support a three category model that aligns loans and securities in a common framework. However, we are concerned with the detailed aspects of the ED's proposed model.

### *Sales of financial assets classified in amortized cost*

The restrictions proposed for the "hold to collect" business model are too narrow to align with actual yield-based business models in practice, and would result in basic loan portfolios failing to qualify for amortized cost. The ED's discussion of permissible and impermissible sales is so restrictive, the guidance, in effect, brings today's "held to maturity" restrictions for securities into the loan accounting model. We do not believe this result reflects the economic substance of common lending activities and the related risk management.

The proposed standard takes a very restrictive view of any sales of financial assets from the amortized cost classification. To be consistent with the objective of the amortized cost classification, sales must be either (i) related to significant credit deterioration of the obligor or (i) isolated, nonrecurring, unusual for the entity, and resulting from events that could not have been reasonably anticipated. The proposed standard explicitly indicates that sales of financial assets resulting from managing credit exposure due to concentrations of credit risk would not be consistent with the objective of the amortized cost classification. The restrictions on sale out of the amortized cost category would effectively prohibit typical credit risk management of banks' retained loan portfolios.

The objective of credit risk management within a retained loan portfolio is to preserve capital by preventing or mitigating credit losses expected to arise from idiosyncratic or systemic events on assets that are intended to be held for collection. This is fundamentally different from the objective of a market maker, which is more inherently focused on current market prices. It is also very different from the objective of asset and liability management, which is to maximize returns from investing excess cash of a financial institution while managing the liquidity and structural interest rate exposure (i.e., any mismatch between a firm's interest income and interest expense profiles), where assets sales

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will be driven by market factors, including but not limited to credit risk, and more frequently, changes in our structural interest rate exposure. Therefore sales of financial assets that are consistent with the credit risk management objective of a retained lending portfolio should be consistent with amortized cost accounting for those assets.

### Sales due to concentration of credit risk

To manage the credit risk of a retained loan portfolio a bank often sets credit concentration exposure limits, typically by considering factors such as obligor group, industry, risk ratings, region and exposure tenor. These limits are reviewed on a periodic basis according to risk appetite and the credit environment, and the credit exposure is monitored within the retained portfolio against those limits. To remain within these limits, a bank may undertake a number of risk mitigation strategies including hedging with derivatives, purchasing guarantees or transferring loans via assignment or sub-participation. Because the risk management objective is to preserve capital, banks take pre-emptive action (including by selling loans) to manage and mitigate credit risk before an extreme loss is incurred. The ability to take pre-emptive action (including limiting exposures by obligor, industry, geography, risk rating, etc. in advance of observed deterioration) is an essential component of a lender's credit risk management of its retained loan portfolio. If sales of financial assets due to concentrations of credit risk or the emerging deterioration in credit risk of a borrower are viewed as inconsistent with the objective of the amortized cost classification, we are concerned that the restrictions to the amortized cost category would result in either a) classification of most loan portfolios in the fair value through net income category (a result generally criticized by constituents responding to the FASB's exposure draft in 2010), or b) placing significant limitations on effective risk management (resulting in higher credit losses) or c) limiting extensions of credit to only obligors of the highest credit quality (thus limiting the availability of credit to other borrowers) in order to mitigate the credit risks associated with a retained loan portfolio.

### Other sales from amortized cost that should be permissible

We also disagree with the ED's view that sales resulting from reasons other than managing credit exposure should be infrequent, isolated, nonrecurring, unusual and not reasonably anticipated. Under certain circumstances, banks have sold, and may in the future consider selling or be compelled to sell, loans held in the amortized cost category. Although such sales do not occur frequently, it is not clear whether such sales would be appropriate under the ED, since the ED defines in fairly specific terms the circumstances under which sales from the amortized cost category are acceptable. While banks do sell certain portfolios of nonperforming loans (which would be acceptable under the ED), the following are other reasons that a bank may sell performing loans, either individually or as a portfolio:

- A bank may choose to exit a product line (perhaps one that is insignificant to its operations overall);
- A bank may have loans that are serviced by a particular third-party servicer with whom it desires to terminate the relationship. The most expedient way to exit the servicing relationship may be to sell the underlying portfolio of serviced loans.
- For co-branding and similar arrangements in the credit card business, it is relatively common for partner agreements to have a contractual expiration date. It is also fairly common for these

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contracts to have provisions that allow the lender/servicer's partner to purchase the portfolio of loans originated under the arrangement (along with the related servicing) at fair value upon the expiration or termination of the contract. This provision gives the partner the ability to have all of its loans serviced by one lender in the event that the original lender and partner decide to part ways, and the partner chooses to enter into a new partnership agreement with a different lender/servicer.

Rather than restricting sales from amortized cost based on frequency or significance, we believe that such sales should be restricted based on the nature of the activity. We agree that opportunistic sales stemming from price changes, trading or market-making activities should be prohibited for financial assets in the amortized cost category. However, activities resulting from credit risk management or loss mitigation associated with holding financial assets, and selling as a result of external triggers not related to price, should be permitted.

### *Level at which the business model is assessed*

We perceive a difference in the level at which business models are assessed in the ED, as compared to the level at which a change in the business model is evaluated. 825-10-55-28 and BC165 discuss the assessment occurring at the portfolio level, and we concur with that level. However, the discussion in 825-10-35-22 discusses that a change in a business model must be significant to the entity's operations, and must be demonstrable to external parties, which indicates that the business model may be intended to be assessed at a level higher than the portfolio level, perhaps even the reportable segment level. Assessments at higher levels would be problematic, because a single reportable segment may manage portfolios of financial instruments under a number of separate business models.

For example, our Corporate and Investment Bank segment includes our primary dealer market making activity in derivatives and financial instruments, and also includes our wholesale loan portfolio that is held for investment. Similarly, our Consumer & Community Banking segment originates and purchases loans specifically for sale via securitization and uses derivatives to manage the economic risks inherent in this loan warehousing activity and its mortgage servicing rights; this segment also has a significant held for investment loan portfolio. Segment level management personnel focus on market price information for market making portfolios, and focus on credit analytics for lending portfolios. This different focus is reflected in the related risk management and compensation, as contemplated in the ED's business model test.

Given the examples above, the business model test should be applied at the lowest level at which there is a separately identifiable business model, which may be at the asset portfolio level. If the assessment is required to be performed at an inappropriately high level, some portfolios will not reflect the measurement that would best project future cash flows. Paragraph 825-10-55-28 and 825-10-35-22 should be clarified on the level at which the business model should be assessed.

<p><b>Question 12:</b> Should the classification and measurement model for financial instruments contain an explicit tainting notion or should it rely on the principle and exercise of professional judgment? Why?</p>
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*Implicit tainting notion*

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We strongly support the absence of an explicit tainting notion from the classification and measurement model for financial assets; however, we are concerned that the ED, as drafted, effectively includes an implicit tainting provision. However, it is our understanding that sales from an amortized cost portfolio would not result in a reclassification of the assets sold, but instead could call into question the initial analysis of the entity's business model for those assets. Assuming, as is likely, that the assets were not sold for one of the specific reasons set forth in the ED, this would seem to inherently call into question the validity of the business model analysis originally applied to the remaining assets in the amortized cost portfolio. Since the consequence of such questions regarding the appropriateness of the initial business model analysis would likely involve restatement of prior period results, we believe that the tainting notion, while not explicit, would remain a significant concern of financial statement preparers and auditors.

Even assuming that questions regarding the initial business model analysis would not lead to restatement, it is our understanding that such sales could lead to a prospective prohibition on the classification of similar assets (or an entire portfolio if there is no way to distinguish which assets would be similar) in amortized cost. This is akin to the tainting notion that exists today in the U.S. with respect to held to maturity securities.

Because the proposed restrictions of financial assets from amortized cost category in the ED are very similar to the extremely onerous restrictions that currently apply to sales of held-to-maturity securities, the tainting notion effectively appears to have expanded in scope under the ED to all financial assets accounted for at amortized cost, rather than having been eliminated.

Accounting standards cannot be expected to contemplate all of the risk environments and other drivers of a need to change the ultimate disposition of financial assets. In order to truly remove the tainting notion, the framework must allow sales out of amortized cost. Sales could be reasonably restricted through (i) an assertion at acquisition or origination that the entity intends to hold the financial asset for the foreseeable future, and (ii) a requirement that a valid business purpose (other than for profit or loss recognition) must be present in order to reclassify a debt instrument out of amortized cost. We believe that any concerns regarding transparency of gains and losses on sales out of amortized cost can be addressed via disclosure.

### **Recognition – Loan Commitments, Revolving Lines of Credit and Commercial Letters of Credit**

**Question 13:** The proposed amendments would require loan commitments, a revolving line of credit, or a commercial letter of credit (the potential creditor) to be measured on the basis of the likelihood of exercise of the commitment and the classification of the underlying loan that would be made upon exercise of the commitment. Do you agree with the proposed classification of loan commitments? If not, why? What would you propose instead?

We believe that for all classification categories, loan commitments, a revolving line of credit, or a commercial letter of credit (collectively, "loan commitments") should be measured based on the classification of the underlying loan that would be made upon exercise of the commitment. We believe that the accounting symmetry between the classification and measurement of loan commitments and any funded loans within a single business model is logical and appropriate.

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Under current US GAAP, Subtopic 310-20 requires an assessment of the likelihood of exercise to determine the accounting for loan commitment fees, as either: deferred until a loan is funded, and then recognized as a yield adjustment to the loan (not remote of funding) or deferred as a liability and recognized ratably over the commitment period. We support this guidance for fees, and note that the original guidance applied to debt instruments that were held for investment, and not other measurement categories at fair value. Consequently, while we support the guidance to consider likelihood of exercise of the commitment, we think that it should be contained to only the amortized cost classification.

## **Initial Measurement**

**Question 14:** Do you agree with the initial measurement principles for financial instruments? If not, why?

We generally support the guidance in paragraph 825-10-30-1, which provides that an entity shall initially measure a financial instrument consistent with its subsequent measurement. However, we have some concerns about the scope and clarity of the guidance in paragraphs 825-10-30-4 through 825-10-30-6, which addresses situations where the transaction price includes consideration for something other than the financial instrument.

With respect to the scope, we note that ASC 310-10-25-7, which provides guidance on allocating the cost of a purchased credit card portfolio between the value of the loans and the value of the underlying relationships, is being amended such that it would be subject to paragraphs 825-10-30-4 through 825-10-30-6. In practice, financial institutions presently account for purchased credit card portfolios in accordance with ASC 310-25-7 and ASC 805-50-30, "Acquisition of Assets Rather than a Business" (the latter is not being amended in connection with the ED). As a result of applying ASC 310 and 805, purchasers allocate the overall purchase price of a credit card portfolio to the individual assets acquired (i.e., the value of the credit card loans and the value of the customer relationship intangible) based on their relative fair values. We believe that there is a fundamental difference between the acquisition of a credit card portfolio and the origination of an individual credit card loan. The pricing of credit card portfolios includes both the value of the loans and the value of the underlying relationships. On the other hand, it would be extremely difficult to attribute "relationship value" to any individual credit card loan (or other type of loan) originated. Accordingly, we believe that ASC 310-10-25-7 should not be amended, in which case entities would continue to account for purchased credit card (and other loan) portfolios by allocating the purchase price to the individual assets acquired based on their relative fair values (i.e., in accordance with ASC 310-10-25-7 and ASC 805-50-30).

We also believe that the phrase "something other than the financial instrument" as used in paragraphs 825-10-30-4 through 825-10-30-6 is overly broad and ambiguous. "Something other than the financial instrument" could be interpreted to apply to the value of an intangible element of the transaction, such as a borrower relationship or the opportunity to gain market share. As discussed above, it would be extremely difficult and also highly subjective to attribute a relationship value or similar intangible to any individual loan origination transaction. Therefore, we request that this guidance be clarified such that accounting recognition is given to situations where the transaction price includes consideration for a specified good or service, an individual identifiable asset, or a liability other than the financial instrument.

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## Subsequent Measurement

**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?

Changing the current fair value option election in existing U.S. GAAP to an election based on a new set of criteria will not improve the decision-usefulness of financial information. The current fair value option is generally applied by companies to reduce an accounting mismatch or alleviate accounting complexities (e.g., application of hedge accounting or bifurcation of embedded derivatives). These mismatches and complexities tend to arise in the same types of financial instruments and investments held by comparable reporting entities, and therefore tend to result in similar uses of the fair value option by peer firms. We therefore question whether there is significant inconsistency in the application of the fair value option across similar investments within a given industry. If the FASB is concerned over lack of comparability under the current fair value option rules, we believe this can be addressed through evaluating current disclosure requirements for possible enhancement to provide any missing transparency to users of financial statements regarding the use of the fair value option while eliminating the need to develop additional rules as to when fair value elections may be made.

**Question 16:** Should financial liabilities subsequently be measured at amortized cost, unless certain exceptions are met? If not, why?

Yes. We believe, unless certain exceptions are met, amortized cost is the most relevant measure for financial liabilities. For a going concern, amortized cost reflects the amount of the liability that a creditor would receive upon settlement. Please see our comments on the fair value option and bifurcation in Questions 4 and 15 for a discussion of the circumstances in which amortized cost would not be relevant for the entire instrument.

**Question 17:** The proposed amendments would require a nonrecourse financial liability that is settled with only the cash flows from the related financial assets (see paragraph 825-10-35-11) to be measured on the same basis as those assets. Do you agree with the proposed amendments? If not, why? What would you propose instead?

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We conceptually support the Board's effort to provide a means to eliminate certain accounting mismatches by requiring nonrecourse liabilities be measured similarly to the related assets. However, there are some complexities inherent in the proposed guidance that have yet to be considered by the Board.

For example, it is not clear how an entity should take into account "the same factors" that are used in measuring the financial assets as required in paragraph 825-10-35-11. If the assets are accounted for at FV-OCI, and they experience a credit loss, is it the Board's intent that the liabilities always be adjusted for that credit loss, or would it depend if the assets had an aggregate carrying value that was higher or lower than that of the nonrecourse liabilities?

As another example, it is not clear whether nonrecourse financial liabilities must first be considered for bifurcation under the proposed measurement model before applying the nonrecourse liabilities guidance. Since application of bifurcation requirements may result in an accounting mismatch between the assets and the nonrecourse liabilities, such application may not be the FASB's intent.

In the cases above, we believe it would be useful for the FASB to make its intent clear in the final Accounting Standards Update. We encourage the FASB to consider other illustrative examples in its redeliberations of the ED.

**Question 18:** The proposed amendments would require financial assets measured at amortized cost that are subsequently identified for sale to continue to be classified and measured at amortized cost less impairment and would prohibit recognition of the gain, until the sale is complete. Do you agree with the proposed classification and measurement requirements? If not, why?

We support the proposal that financial assets measured at amortized cost that are subsequently identified for sale continue to be classified and measured at amortized cost less impairment and that gain recognition be prohibited until the sale is complete. We agree that the measurement of impairment should reflect the difference between amortized cost and fair value (if lower than amortized cost).

However, the ED is not clear on how the requirements relating to assets subsequently held for sale relate to the application of the business model test. Assuming the business model test operates at a portfolio level (see our responses to Questions 3, 10 and 11 with regards to the business model test), we note that this guidance operates at an asset by asset level. Furthermore, the business model test envisaged by the ED is very restrictive on allowing sales out of the amortized cost category and has an effective tainting notion (please see our response to Questions 11 and 12), which seems at odds with the guidance in 825-10-35-14, which implies no such restrictions. It is also not clear what would happen if a reporting entity no longer intends to sell an asset that was identified as for sale. Would the financial asset be returned to amortized cost accounting and, if so, at what value?

Finally, the disclosure requirements in 825-10-45-7/8 are confusing, particularly where the fair value is less than cost less expected credit losses on the date that an asset is identified for sale. Paragraph 825-10-45-8 requires an asset to be reported at fair value with parenthetical disclosure of the amortized cost less allowance for expected credit losses when the fair value is less than the net carrying amount. Given the requirement in 825-10-35-14 to impair assets subsequently identified for sale down to their fair value, the fair value of such assets can never be less than the carrying value, and the measured

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value and "presented" value would be the same, i.e. the fair value of the asset. Lastly, we do not understand how to "present" an asset at fair value when it is "measured" on a different basis (i.e. amortized cost less allowance for expected credit losses).

**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?

We support a practicability exception for measuring equity investments without readily determinable fair values, but believe that investments without readily determinable fair values that are held for strategic purposes (such as investments in certain joint ventures, clearing corporations, etc.) are best measured on the balance sheet at their original cost, less any impairment. This is because the economic benefits of such investments generally do not relate to a future sale at a market price, but rather are derived from ongoing business activities unrelated to the fair value of the investment. Further, such impairment should be based on an 'other-than-temporary' impairment model rather than a 'more likely than not' impairment model, since the value of strategic equity investment is predominantly obtained from revenues unrelated to the sale of the investment. Please see our response to Question 35 for further comments on the impairment model for equity securities.

**Question 20:** Should an entity evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income separately from the other deferred tax assets of the entity (rather than combined and analyzed together)? If not, why?

We do not object to the FASB's conclusion that the need for a valuation allowance on deferred tax assets related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income should be evaluated separately from other deferred tax assets. We note that an entity's decision to retain a debt security until maturity or recovery is akin to a tax planning strategy (used to overcome the need for a valuation allowance under existing literature) that would also result in the reduction of the deferred tax asset as the debt security recovers in value. We believe this anticipated reduction of the deferred tax asset as the unrealized loss is reversed in OCI is part of the basis for the FASB's conclusion, and believe that the FASB should clarify its reasoning in the basis for conclusions to attempt to differentiate this circumstance from other temporary book-tax differences.

We believe that the FASB's proposed approach would mitigate issues regarding the current prohibition related to "backwards tracing" of certain tax items. We note that, according to the Consequential Amendments, if a valuation allowance was subsequently required, it would be recorded through earnings and as a result would not align with the DTA, which was recognized through other comprehensive income. We believe that a subsequent valuation allowance related to the DTA associated with assets measured at fair value through OCI is just one example of operational complexities surrounding backwards-tracing issues under current US GAAP and would support a re-evaluation of these matters more broadly by the FASB. In this regard, we agree with the approach

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under IFRS which requires various tax adjustments and remeasurements to be traced back to the underlying items and recorded consistently with the treatment of the initial item.

We also believe that the FASB should clarify paragraph 825-10-35-16, which refers to "deferred tax asset related to unrealized losses on a financial instrument classified in the fair value through other comprehensive income category." We believe that "unrealized losses" is intended in an accounting context (losses that have not been recognized in earnings) and not in an economic context (losses that have not been realized through a sale), and that this provision is not intended to apply to situations where a Firm has recognized an impairment through earnings (and created a deferred tax asset) but has not yet realized that loss through a sale of the security.

### **Subsequent Measurement – Hybrid Financial Instruments**

**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?

We do not agree with the proposal to classify hybrid assets in their entirety on the basis of the proposed classification requirements. Please see our response to Question 4 for further details.

### **Subsequent Measurement – Reclassifications**

**Question 22:** The proposed amendments would require reclassification of financial assets when a change in business model occurs and prescribes how those changes should be subsequently accounted for. Do you agree with the proposed amendment on reclassifications? If not, why?

We generally agree that reclassification of financial assets should occur when a change in business model for the portfolio occurs, and also agree with the subsequent accounting for such reclassifications as set forth in the ED.

Considering the uncertainties in the application of the business model principle discussed in our responses to Questions 3, 10, and 11, it is unclear how the guidance in 825-10-35-22 (Reclassification of Financial Assets) would apply in practice. This guidance indicates that "A change in the business model must be determined by an entity's senior management as a result of external or internal change, must be significant to the entity's operations, and must be demonstrable to external parties." If a large diversified institution were to appropriately determine that it operates under a significant number of individual business models, it is much less likely that a change in any one of these individual business models would be significant to its operations, which in turn suggests that it would be very difficult for the entity to ever reclassify financial assets in the event of a business model change for a particular portfolio.

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For example, consider a large, diversified financial entity that comprises several businesses that both invest in and trade financial assets and that also offers numerous types of lending products to wholesale and retail customers. Further assume that as part of its consumer lending portfolio, the entity has originated a relatively small portfolio of auto loans that are measured at amortized cost. If the entity were to determine that, for strategic business purposes, it no longer wanted to be in the auto lending business, it may decide to sell its auto loan portfolio. However, assuming that the entity's auto lending business is not significant to its overall operations, presumably this is not a business model change that would warrant reclassification under the ED. If reclassification is not appropriate, then it appears that the only remaining alternative would be to sell the auto loan portfolio directly out of the amortized cost classification. Again, this would appear to be problematic and may implicitly give rise to a tainting issue if such a sale were deemed to be not consistent with the criteria set forth in 825-10-55-31 and 32.

We believe that a change in business model should be determined by management with responsibility for the relevant portfolio and that the change must be demonstrable and significant with respect to the portfolio as a whole.

## **Presentation**

**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?

We strongly support providing clear and transparent disclosure of the fair value of instruments that are carried at amortized cost. However, only the primary accounting measurement basis should be reflected on the balance sheet. By presenting the fair value of amortized cost financial instruments on the face of the balance sheet the Board would be giving equal prominence to an alternative measurement basis that has already been determined to be of secondary usefulness by the FASB's constituents. It will also be disorderly presentation for users to navigate; for a particular line item the such as loans, the balance sheet will show the carrying value, the amount of that carrying value that relates to instruments that are carried at fair value and the fair value of the instruments that are carried at amortized cost. It is clearer and more useful to users for the fair value of instruments carried at amortized cost to be presented prominently in the note to the financial statements, with relevant qualitative information for context.

**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?

We believe that presenting in other comprehensive income (rather than earnings) changes in fair value attributable to changes in the issuer's own credit risk ('debit valuation adjustments or 'DVA') that cannot be monetized in any meaningful way would provide decision useful information. The Board

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should also consider whether such an improvement should be applied to all financial instruments and not limited to a subset thereof. Users of financial statements generally exclude all DVA from our results when making decisions, and do not differentiate between DVA from fair value option liabilities and DVA from derivatives.

We are supportive of the requirement in 825-10-45-18 to include all *realized* gains and losses (rather than *cumulative* gains and losses, as proposed in the ED) and attributable to changes in an issuer's own credit risk in the income statement. This is consistent with the principle that realized gains and losses should be reclassified out of OCI and into income, and is consistent with a number of other areas of financial instruments accounting, including; (i) the requirements of 825-10-35-12 for realized gains and losses relating to financial instruments with changes in net income reported in OCI (ii) and cash flow hedge accounting where gains and losses on a hedging instrument are reclassified from OCI to income when the underlying hedged item affects income. Finally, we suggest that the references to instrument-specific credit risk be changed to issuer-specific credit risk for the avoidance of any doubt about the FASB's intent related to financial liabilities linked to the credit risk of entities other than the issuer.

**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?

We support recognizing foreign currency gains and losses in net income for debt securities measured at fair value through other comprehensive income. However, we believe that the method specified in IFRS 9 should be a permitted method to measure the foreign currency gain or loss.

Under IAS 21, which is carried forward in IFRS 9, a foreign currency monetary available-for-sale financial asset is treated as if it were carried at amortized cost in the foreign currency. Foreign exchange differences from changes in amortized cost are recognized in net income and unrealized gains or losses on price changes of an available-for-sale asset remain in OCI. The difference between the FASB's proposal and the IFRS method for allocating foreign currency gains and losses to net income would be problematic for multi-national institutions with both GAAP and IFRS subsidiaries as some general ledgers may only support a single method.

The IFRS 9 method also aligns the recognition of foreign currency gains and losses from foreign currency-denominated debt securities with how the positions may be funded with foreign currency liabilities. For example, if a USD functional entity purchases a GBP-denominated debt security measured at FV-OCI, that asset purchase is often funded with a GBP liability (e.g. GBP deposits or GBP long-term debt) that is accounted for at amortized cost. The foreign currency movements related to the GBP liability are calculated based on the amortized cost times the changes in the spot rate and are recorded as part of the remeasurement process. Under the IFRS 9 method, both the GBP-denominated asset and related liability are matched for foreign currency movements.

Therefore, we recommend that the IFRS 9 method be identified as an acceptable approach to measure foreign currency gains and losses.

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## Disclosures

**Question 27:** The proposed amendments would require a public entity to provide disclosure of the core deposit liability balance, implied weighted-average maturity period, and the estimated all-in-cost-to-service rate by significant type of core deposit liability. Do you agree with the proposed disclosure requirement and, if so, how would you use that information? If not, what information should be provided and why? Is it appropriate not to require this information for nonpublic entities?

We do not object to disclosing the balance of the core deposit liability; however, because different institutions may define core deposits in very different ways, we believe that it is important for the Board to provide an expanded level of qualitative guidance in terms of the types of liabilities that should and/or should not be included in core deposits. Otherwise, we expect that there would not be a high level of comparability among disclosures across the industry.

However, we do not support the proposed requirements to disclose the implied weighted-average maturity period or the estimated all-in-cost-to-service rate by significant type of core deposit liability. We do not believe these disclosures would provide useful information outside the context of more comprehensive disclosures about liquidity and interest rate risk management. Therefore, the Board should eliminate these proposed disclosures from the scope of the ED and address them in its ongoing “Liquidity and Interest Rate Risk Disclosures” project once the relevant work on the disclosure framework has been completed.

**Question 28:** Are there any other disclosures that would provide decision-useful information and why?

**Question 29:** Do you agree with the proposed disclosure requirements? If not, which disclosure requirement would you change and why?

Several of the proposed disclosures are either currently disclosed or require information that is readily available. However, we have noted certain proposed disclosure requirements where we do not agree with the requirement or the proposal is redundant to existing disclosure requirements. The following comments on the proposed disclosure requirements are organized by financial instrument category:

### *Financial Instruments for Which All Changes in Fair Value are Recognized in Net Income*

For debt instruments that are carried at fair value, the ED (paragraph 825-10-45-9) would require entities to present on the face of the balance sheet the amortized cost of those debt instruments. We question the usefulness of this requirement, in particular for certain types of debt instruments such as structured liabilities. Determining an amortized cost for structured liabilities can be complicated because of their unique terms and since many systems are not capable of performing the requisite accrual based accounting (e.g. the retrospective interest income method). The current disclosures regarding contractual principal outstanding for financial liabilities elected under the fair value option are sufficient, and we believe that a requirement to determine and disclose the amortized cost (whether in the notes or on the face of the balance sheet) would be onerous and of little use to users of financial statements.

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## *Financial Instruments Measured at Amortized Cost*

Paragraph 825-10-50-34 of the ED would require disclosure of additional information for financial instruments that are measured at amortized cost. In particular, it requires disclosures of quantitative information about the significant unobservable inputs used in Level 3 fair value measurements. We disagree with requiring this additional detailed information regarding fair value measurements for items that are not carried at fair value in the financial statements, and thus for which fair value has been determined to be of secondary usefulness in projecting future cash flows. For the same reason, we question the benefit of providing additional qualitative fair value measurement disclosures for items that are held at amortized cost. Therefore, we ask the FASB to reassess the costs and benefits of requiring this information to be provided.

## *Nonrecourse Financial Liabilities*

Paragraph 825-10-50-40 requires that an entity with nonrecourse financial liabilities disclose both the qualitative information about the relationship between the financial assets and nonrecourse financial liabilities used to settle them, the line items they are reported and the carrying amounts of the financial liabilities and related financial assets. These requirements are duplicative of the information currently required to be disclosed by ASC 810-10-50-3, which was not amended in the Consequential Amendments. Due to the redundancy, we suggest the disclosure requirements in this section be removed and that ASC 810-10-50-3 remain intact.

## *Equity Investments without Determinable Fair Values*

We believe the additional disclosures proposed for equity investments without readily determinable fair values (ASC 825-10-50-42) are excessive; other than the difference in measurement technique, we cannot discern a reason for requiring such detailed, specialized information for this particular asset class, which for many preparers is likely to be immaterial. Requiring quantitative information about the cost and carrying value, and qualitative information about the measurement calculation and inputs would be more consistent with disclosure requirements for other equity investments, and would add less volume to the already voluminous fair value disclosures. Please refer to our responses to Questions 19 and 35 for our views on the appropriate measurement for strategic equity investments.

### **Transition and Open Effective Date Information**

**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 agree that preparers should be permitted to adopt this proposed presentation requirement as soon as possible to render the income statement more useful. The change is operational and is easy to separate from the other proposals in the Exposure Draft.

**Question 32:** How much time is needed to implement the proposed guidance?

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The time needed to implement a final Accounting Standards Update will be highly dependent on the extent of changes made during redeliberations. If issued as proposed, the complexity of the SPPI test and the significant differences in classification as compared to current US GAAP (for example for basic loan portfolios no longer qualifying for amortized cost) would require at least three years for interpretation, education and systems development. If, however, the changes to current US GAAP were much more targeted as described in our Summary Comments, the time required for implementation would be greatly reduced. We also acknowledge the importance of aligning the implementation time period with the proposed Accounting Standards Update - Financial Instruments - Credit Losses.

**Question 33:** Are the transition provisions in this proposed Update operable? If not, why?

The transition provisions would be improved by expanding application of the reclassification guidance in 825-10-35-23a2, which provides for the fair value of the financial assets at reclassification date as the assets' new carrying value for amortized cost basis. We request that this guidance be applied to all financial instruments (including equity method investments) currently recognized under the fair value option which will be required to be classified under the equity method of accounting under the Proposed Update.

## **Equity Method Accounting**

**Question 34:** The proposed amendments would require investments that qualify for the equity method of accounting in Subtopic 323-10, Investments—Equity Method and Joint Ventures—Overall, to be subsequently measured at fair value with changes in fair value recognized in net income if the investment is held for sale at initial recognition. Are the proposed indicators/conditions operable? If not, why? What would you propose instead?

We disagree with the proposal to require equity method investments to be carried at fair value if the investment is held for sale at initial recognition because the criteria used to define “held for sale” appear overly broad and would capture equity method investments not expected to be exited at fair value. For example, certain investments in partnerships and limited liability companies currently subject to the equity method of accounting have limited lives, and therefore it could be interpreted that the proposed ASU would require these equity method investments to be carried at fair value with changes in net income. Similarly, many affordable housing and energy investments could also meet these criteria because most of these investments have a defined time horizon over which tax credits from the investment will be realized, and in some cases, merchant banking rules may place limits on the length of time such positions can be held. These factors may unintentionally require the investments to be classified as held-for-sale and accounted for at fair value. In addition, requiring investments such as affordable housing to be carried at fair value is not representative of the amount and timing of the benefits provided to the investors. Investors realize the return on their investment as they receive the periodic tax benefits and any cash distributions, as opposed to an investment that is made for capital appreciation where the return is realized once the investment is sold.

Rather than attempting to reconstruct a new definition of held for sale that could address these fact patterns, we believe the fair value option should be retained for equity method investments. This

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would maintain the ability to record equity method investments at fair value if the intention is to sell in the short term. As previously discussed in our response to Question 15, we do not believe that there is significant inconsistency in application of the fair value option for similar investments within industries. However, if the FASB is concerned over lack of comparability under the current fair value option rules, we believe this can be addressed through evaluating current disclosures for any additional transparency needed.

We also question the usefulness and timing of the scope for equity method investments. Equity method investments are not in scope under most circumstances in the proposal, but in scope if held for sale as well as for impairment. We do not believe introducing an inconsistent scope for equity method investments is appropriate. We also note that certain equity method investments are being reviewed under separate projects, e.g., Proposed Accounting Standards Update—*Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects* (formerly EITF Issue 13-B) regarding the accounting for investments in tax credits. If the FASB believes improvements are necessary in the accounting for equity method investments, the FASB should engage a comprehensive review rather than dealing with individual and narrow issues in isolation.

**Question 35:** The proposed amendments would change the current two-step impairment model for equity method investments to a one-step impairment model for all equity investments. Do you agree with the proposed one-step equity impairment model? If not, why? What would you propose instead?

We do not agree with the proposed change to the impairment model for equity investments. We believe that a model that will require an impairment charge if it is more likely than not that the fair value of the equity method investment is less than its carrying value would ignore whether a decline in fair value is considered temporary for equity method investments that are held for long term strategic operating purposes, and where a short term decline in fair value is not particularly relevant for financial statement users. Many of these investments generally do not have a readily determinable fair value and the estimated value itself requires significant unobservable inputs. The estimated value may be affected by general market conditions which reflect prospects for the economy as a whole or by specific information pertaining to an industry or an individual company; however such declines may not impact the strategic operating returns to be realized from the investment. To require an impairment charge when it is more likely than not that the fair value is less than its carrying value at any reporting date would ignore:

- Intent and ability of the holder to retain its investment in the equity method investment for a period of time sufficient to allow for any anticipated recovery in market value; and
- The length of time and the extent to which the market value has been less than cost.

There are numerous factors to be considered in the determination of whether an equity method investment is impaired and their relative significance will vary from case to case. We believe the appropriate impairment model for equity method investments that are held for strategic operating purposes would be an other-than-temporary impairment model (OTTI), as the returns from such investments will be from operating revenues rather than from sale. For these investments, based on

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the considerations above and other factors, an impairment should be recognized when it is more likely than not that the loss is other-than-temporary.

## **Nonfinancial Hybrid Instruments**

**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 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?

We agree with the Board's proposal to allow the application of the fair value option to hybrid nonfinancial liabilities with embedded derivatives requiring bifurcation, however, we do not believe the change should be introduced at the expense of removing the current fair value option guidance for financial instruments. As previously addressed in our response to Question 15, we do not believe changes to the current fair value option election for financial instruments should be made. If the Board desires symmetry in the fair value option between hybrid financial and nonfinancial instruments, such an amendment could be made in the context of the existing fair value option, amending current U.S. GAAP (paragraph 825-10-15-4(f)) to explicitly allow the fair value option to nonfinancial instruments.

## **Other Comments**

### *Recognition - Principal*

In the proposed ASU, the stated recognition principle requires recognition on the balance sheet of a financial instrument as either a financial asset or a financial liability upon acquisition or incurrence. The principle as currently drafted does not appear to contemplate loan commitments, which are financial instruments, but may not be recognized on the balance sheet until a loan is drawn. Specifically, we note that for loan commitments, where the likelihood of exercise is deemed not to be remote at inception and where the underlying loan will be classified as amortized cost, the loan commitment may not be recognized on the balance sheet and would appear to be in violation of this principle. We recommend clarifying the language to avoid any confusion that the proposed ASU is requiring recognition of loan commitments.

### *Pools of Similar Financial Assets*

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Paragraph 825-10-25-30 addresses the accounting for pools of similar assets. We ask the Board to clarify the first sentence of this paragraph, which presently states: “Upon recognition of a pool of similar financial assets, such as a pool of loan receivables, an entity may expect to sell a portion of the pool. . .” As drafted, some may interpret this language to apply only to purchased loans, and not to originated loans, since loans are typically originated and recognized individually, not in pools. In addition, it is unclear why the guidance in this paragraph is limited to the accounting upon recognition. Notwithstanding the fact that the ED places restrictions on subsequent sales, it is possible that such sales may occur and that the guidance set forth in this paragraph should be applied to those transactions as well (i.e., clarify that the unit of account should be at the pool level rather than the individual loan level for transactions subsequent to recognition).

Notwithstanding our general support for designating the pool as the unit of account, we believe that it would be helpful if the Board were to provide additional guidance on how this pool level accounting would work. For example, even if the pool is the unit of account for classification purposes, it appears that loan level accounting would still be required for other purposes (e.g., disclosures about the credit quality of receivables). This suggests that specific loans must underlie each individual pool of loans, but individual loans may be reclassified into and out of these pools in exchange for other loans as long as the overall pool remains intact.

*Subsequent Measurement*

The language in paragraph 825-10-35-12b refers to “current period amount of credit losses on financial assets” rather than mirroring the language in the proposed Accounting Standards Update *Financial Instrument – Credit Losses (Subtopic 825-15)*, which employs “current period provision for credit losses.” For the avoidance of any doubt, we recommend that the Board use the same language in the proposed Accounting Standards Update *Financial Instrument – Credit Losses (Subtopic 825-15)*.

*Presentation*

825-10- 45-16 requires preparers to present, at a minimum, in a separate line item an aggregate amount of realized and unrealized gains and losses on financial instruments for which changes in fair value are recognized in net income. If interpreted to require all revenues related to fair value through net income assets and liabilities to be presented together, or to prevent the inclusion of other related revenues in the same line, this requirement could prevent preparers from presenting income from related activities in a coherent manner. For example, a diversified financial institution transacting in physical commodity positions, commodity derivatives and financial instruments in a commodities market making portfolio may wish to present all gains and losses from its aggregate commodities-related market making activities in a single revenue income statement line item. As a second example, a mortgage originator and servicer may include in “mortgage fees and related income” all realized and unrealized gains on the mortgage pipeline and warehouse loans, as well as the impact of related risk management activities associated with the mortgage pipeline, warehouse loans and mortgage servicing rights (“MSRs”), all of which are financial instruments measured at fair value; however, this line also includes items such as fees and income derived from mortgages originated with the intent to sell, mortgage servicing fees and changes in the fair value of mortgage servicing rights (an intangible asset). We believe that the most meaningful grouping of revenues should consider all relevant facts and circumstances and should not be dependent solely on the accounting classification.

*Hedging interest rate risk*

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It is unclear whether the proposed amendments to 815-20-25-12 and 815-20-25-43 would continue to permit the designation of loans accounted for on an amortized cost basis as hedged items in fair value hedges of benchmark interest rate risk. Financial institutions designate loans in fair value hedge accounting relationships as part of the asset/liability management function in order to manage the exposure of net interest margin to differences in the interest rates and payment terms of loans and the deposits and debt by which the loans are funded. Regardless of whether the designated loans are retained or sold, they are subject to interest rate risk that will impact earnings in the form of net interest margin. The loss of the ability to designate loans as hedged items would be a significant change in practice. We ask that the FASB retain the current ability to designate loans accounted for at amortized cost as hedged items in qualifying hedges of benchmark interest rate risk.