Investors Technical Advisory Committee
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | Phone: 203 956-5207 Fax: 203 849-9714

Via Email

September 30, 2010

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Exposure Draft, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities--File Reference No. 1810-100

The Investors Technical Advisory Committee ("ITAC") welcomes the opportunity to provide input on the Financial Accounting Standards Board's ("FASB" or "Board") Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* ("proposal" or "exposure draft"). Our input is from our perceptions as users of financial statements with the goal of improving the financial reporting process[1]. We generally believe that the exposure draft would make a significant improvement in the quality of financial reporting for financial instruments and believe it accomplishes the FASB's objective to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments.

This proposal incrementally and more prominently adds fair value information to the reporting package; it does not swap amortized-cost basis reporting for fair value reporting. The proposal would require (1) presentation of both amortized cost and fair value on an entity's statement of financial position for most financial instruments held for collection or payment of contractual cash flows and (2) inclusion of both amortized cost and fair value information in determining net income and comprehensive income. We believe it presents a comprehensive and an all-encompassing solution -- instead of patching up standards in a reactive fashion, the Board is acting proactively and in our view, has provided a robust framework for reporting financial instruments in a manner that would serve investors well. In particular, the proposal is designed to benefit investors

[1] This letter represents the views of Investors Technical Advisory Committee ("ITAC") and does not represent the views of its individual members, or the organizations by which they are employed. ITAC views are developed by the members of the Committee independent of the views of the Financial Accounting Standards Board ("FASB") and its staff. For more information about the ITAC, including a listing of the current members and the organizations in which they are employed, see http://www.fasb.org/investors_technical_advisory_committee/itac_members.shtml.

whether or not they *currently* prefer fair value as the principal basis of reporting for some or all financial instruments.

Users of financial statements often have different informational needs and employ different metrics in their analysis of corporate performance or financial position. We believe that the expansion of the financial statements to include fair value information makes them more useful to a broader audience. None of FASB's constituencies will suffer a loss of information as a result of this proposal, due to inclusion of both amortized cost and fair value on an entity's balance sheet. The required fair value information complements the existing historical cost information, and we see this as a gain for *all* of FASB's constituents. We view the proposal as a comprehensive solution that contains more explanatory power of a firm's financial position and operating results than the current mixed-attribute model, for the benefit of all investors.

ITAC has long favored a single model for the measurement and reporting of financial instruments. Our support for this position is best summarized in this excerpt from our comment letter of September 17, 2008[2]:

> First, and most importantly, fair value measures reflect the most current, complete and accurate estimates of the value of financial instruments, and are based upon an up-to-date assessment of the amounts, timing, and riskiness of the future cash flows attributable to the asset or obligation. As market conditions change, the values, risk profiles and prospective cash flows of financial instruments change as well. It is essential that investors, who provide capital to companies and bear risk as a result, have a clear understanding of the effects of these changes.

While the proposal falls short of requiring a single measurement and reporting model, we nevertheless consider the results it would produce to be vastly superior to the mixed-attribute model in place today and a major step towards our preferred reporting framework.[3]

ITAC would be remiss if it failed to mention that the financial instruments accounting project is a joint effort with the IASB, but unfortunately, only in name. At this point, the two boards are clearly choosing different, isolated paths. We find it unfortunate that the boards cannot find constructive ways to work together on this critical project and we are concerned that the lack of unity on this project does not augur well for the convergence process or to benefit global investors. It may also diminish the support and the momentum achieved for the convergence of IFRS and U.S. GAAP more broadly. The

---

[2] Letter from Michael Moran, Member, ITAC, to Mr. Robert Herz, Chairman, FASB and Sir David Tweedie, Chairman, International Accounting Standards Board ("IASB") 1-2 (Sept. 17, 2008), http://www.iasb.org/NR/rdonlyres/A76C7FF2-E5F0-4585-8322-E7C44539E025/0/CL29.pdf

[3] Letter from Jeff Mahoney, Co-Chair, ITAC et al. to Sir David Tweedie, Chairman, International Accounting Standards Board 8 (Sept. 22, 2009), http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156463408 (Commenting on an alternative approach to the International Accounting Standards Board's classification and measurement of financial instruments that would "move to more fair value in the financial statements [as] provid[ing] a major step towards our preferred answer").

ITAC's view of convergence has been that these efforts should focus on development of improved accounting standards for the benefit of investors, rather than focusing on the development of compromises solely for the purpose of achieving converged standards.[4] This project is not exempt from that view.

Scope

We believe that the scope of the proposal is satisfactorily comprehensive. We agree with the proposal's inclusion of reporting of liabilities at fair value, as well as its extension to deposit-type and investment contracts of insurance entities.

We understand that the application of fair value reporting to deposit-type and investment contracts of insurance entities would require their determination through the use of Level 3 techniques. We also understand that this would be a major break from current practice, but we believe that the resulting information would be more relevant for investors' use in determining the nature and riskiness of these obligations than the information provided by traditional historical cost-based measurements.

The proposal requires application of the equity method of accounting only if the investor has significant influence over the investee and if the operations of the investee are considered related to the investor's consolidated operations. We agree with these proposed changes in equity method accounting and believe the change to require that the operations be related will improve the quality of reported equity earnings, in that it will be more representative of a firm's core business, rather than a cluttered amalgamation of dissimilar earnings.

We also believe the proposed guidance's requirement for measuring financial liabilities, with qualifying changes in fair value recognized in other comprehensive income, will result in enhanced investor understanding of the riskiness and overall hedged position of brokers and dealers in securities. Under the current mixed-attribute model, financial instruments held as assets will fluctuate greatly as a result of changes in the market rate of interest, while issued liabilities carried at their historical cost will be unaffected – even though their value is also affected by changes in the market rate of interest. This mismatch of accounting measurements can lead to a firm appearing to be far more leveraged or far less leveraged than it is in fact. In some cases, the liabilities are issued in order to purchase the financial instruments held as assets, and a natural hedge exists – but the mismatch of accounting measurements obscures the hedged position. We believe that accounting serves investors best when it depicts the status of a firm's financial position without exaggerating it in one direction or another. That's bound to happen when similar

[4] The ITAC believes that the joint financial instruments project, like all convergence projects "should not be a race to the bottom . . . [but rather should be] about improving US GAAP while improving accounting standards around the world." See, e.g., FASB Investors Technical Advisory Committee, Minutes of Meeting ¶ 5, at 2 (Nov. 11, 2008), http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156578870.

instruments are measured on two different bases – and two different bases are used simply because the same instruments appear on different sides of the balance sheet.

There are several members of ITAC who have concerns about the reporting of fair value changes attributable to a firm's own credit standing. Those concerns, and the overall group's view, are discussed in more detail in the "Subsequent Measurement" section.

Initial Measurement

Consistent with our long-standing preference for fair value reporting for financial instruments, we support the proposal's initial measurement principles, including the immediate recognition of significant non-fee differences between a transaction price and fair value on the transaction date. ITAC believes this provision is consistent with our view that fair value represents the most useful measurement basis for investor information. We also believe that such a provision could assist in ensuring transactions that occur at other than market value will be properly disclosed. We also believe that fair value should be the single initial measurement principle regardless of the geography for changes in fair value – that is, whether they are reported in net income or other comprehensive income, there is no reason why anything other than fair value would provide better information.

We acknowledge that this proposal accounts for transaction fees in two different ways - (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income, and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income. We understand that this is necessary in order to preserve amortized cost accounting for those who find it useful. While the former method of reporting transaction fees is our preference, we find that dichotomy to be a workable solution.

Subsequent Measurement

We support and believe that fair value should be the default measurement attribute for financial instruments for both initial and subsequent measurement. We believe that both bases can be satisfactorily presented on the statement of financial position, but we would not support a presentation that displays the historical cost basis with only a parenthetical presentation of the fair value information.

We would note that although the ITAC supports the notion of applying fair value reporting to liabilities, including the recognition of changes in liabilities' value due to an issuing firm's own credit several of its members find the reporting of such fair value changes through either net income or other comprehensive income to be uninformative. In their view, fair value fluctuations due to a firm's own credit do not represent earnings in any sense, and they do not find it useful in assessing performance, nor do they find it useful in estimating future earnings and/or cash flows.

The rest of ITAC's members believe that fair value reporting of own-credit changes is useful to them. They point out that an own-credit gain is absolutely not the same as a traditional recognized gain, yet it conveys information about a firm's prospects and it needs to be interpreted and analyzed. Setting it aside for evaluating normalized performance is one use – but it is not the same as ignoring it. The gain or loss on a firm's own credit communicates to users that credit markets recognize that an economic event has occurred, requiring further evaluation. For example, an investor might establish a "best practice" of evaluating underlying events that have occurred that trigger an own-credit change, with the intention of absorbing that information to determine if that event changes his or her views about the inherent risks of the investment. Without reporting of own-credit value changes, a credit downgrade might occur that such an investor would otherwise miss.

Classifying gains and losses in one-dimensional terms - "gain" as a synonym for "good event" and "loss" as a synonym for "bad event"- gives short shrift to the ability of investors to understand complex, yet highly relevant, concepts related to financial reporting. The majority of the ITAC has confidence that investors welcome information of all kinds and that they will apply more sophisticated analysis than simple "good/bad" classifications of gains and losses, even more so after they have an increased familiarity with it.

ITAC also believes that the proposal has adequately isolated the components of income (such as interest income/expense, credit impairments, and realized gains and losses) that belong in other comprehensive income for those financial instruments meeting the qualifying criteria. We express support for the barring of subsequent reclassifications of a financial instrument's characterization from fair value with changes in net income (FV-NI) to fair value with changes recognized in other comprehensive income (FV-OCI). We believe that this type of guidance would help users in their comparison between companies. We believe that without the prohibition, firms might selectively change their classifications in order to achieve accounting results that are more artificial. For instance, securities might be flipped back and forth from one category or the other, only in order to preserve certain regulatory capital ratios. The gains or losses that might result in net income would not necessarily present a picture of performance that has anything to do with the company's operating business.

ITAC harbors concern over the proposed remeasurement approach for core deposit liabilities. We have long supported the presentation of full fair value reporting to investors. While the proposed remeasurement methodology represents a move away from classic historical cost reporting, it does not result in a fair value presentation. As such, it introduces yet another version of mixed-model reporting to investor reporting. We would prefer that the Board require a fair value presentation of core deposit liabilities that is consistent with the presentation of all other financial instruments covered by this proposal.

While we support the broad use of fair value reporting, we do not oppose the use of amortized cost reporting if the transaction meets the criteria for FV-OCI instruments and measurement at fair value would create or aggravate a measurement attribute mismatch. As we transition to full fair value accounting for all financial instruments, we generally would not oppose accounting requirements that limit measurement mismatches such as those that occur between assets on a fair value basis and related liabilities reported on an amortized cost basis.

We believe that the recognition of qualifying changes in fair value in other comprehensive income will provide decision-useful information to investors, even if an entity intends to hold the related financial instruments for collection or payment of contractual cash flows. The issue of other-than-temporary impairments has long been a thorny issue in financial reporting, and we believe that this style of fair value reporting will defuse the issue. It will present a clear depiction of market views on the realizability of such financial instruments. The presentation of fair value figures paired with corresponding amortized cost throughout the financial statements will also provide investors with more assurance that the amounts on both bases have been prepared with a higher degree of caution than if one or the other had been presented in the footnotes.

ITAC also believes that the proposal’s fair value treatment of hybrid instruments is simpler for firms to apply and for investors to understand than the bifurcation treatment required by IFRS 9, which we view as a sheltering extension of the amortized-cost approach. The change reflected in net income will provide immediate information to investors about the results of hybrid financial instruments in investing and financial structure decisions – information that is not as immediate in an amortized-cost basis setting.

We support the proposal’s requirement to measure certain short-term receivables and payables at amortized cost. For these instruments, we believe the effort to measure them at fair value may outweigh the benefit that would be derived therefrom.

Presentation

We believe it is appropriate to require a separate presentation of changes in an entity’s credit standing in net income for financial liabilities measured at fair value with all changes in net income. We believe that including all such changes draws investor attention to all of the factors that affect a firm’s performance. We consider it imperative that such changes recorded in net income be required to be completely, clearly and separately disclosed in the income statement. While equity investors would want to know the information conveyed by debt market participants in *their* valuation of the firm’s liabilities, they would not want to capitalize such gains in their valuation of equities, nor would they want to discount their valuations for any similar losses.

For financial instruments measured on an FV-OCI basis, we believe the information provided to reconcile amortized cost to fair value will be sufficient to inform investors of any divergence in the valuation views of management from the valuation views of market participants.

Credit Impairment

The proposal would require an entity to recognize in net income at each financial reporting period the amount of credit impairment related to all contractual amounts due for originated financial assets that the entity does not expect to collect and all amounts originally expected to be collected for purchased financial assets that it does not expect to collect. We believe the credit impairment model as outlined provides a clear objective, and we support it. In our view, the credit impairment model would logically expand the loss allowances associated with financial instruments, without permitting forecasts of future losses over their life as would be required under the IASB Exposure Draft, "Financial Instruments: Amortised Cost and Impairment." We hold that the proposal's removal of the probable loss threshold is an improvement to the estimation process that will permit more timely recognition of credit impairments, whereas we hold that the IASB model makes the loss estimation process comparatively malleable. We believe the proposal's requirement for immediate recognition provides more timely information about credit impairment than spreading it over the life of an instrument as an adjustment of interest income. We also support the proposal's approach for requiring historical loss rates for pools of similar financial assets; if applied as described, the results obtained from this approach should produce loss estimates that provide valid estimates of value diminution.

Interest Income

The proposal would require interest income to be calculated on an instrument's amortized cost basis after consideration of credit impairments or recoveries of credit impairments. We support this approach; events that affect a financial instrument's basis, in turn, will have an effect on the income to be realized from that instrument. Ignoring that effect would suppress information about the income to be derived from that particular financial instrument. We also believe, however, that it would be useful for investors to know what would be the contractual amount of interest income recognized. The difference between the interest income calculated under both bases would provide investors with a measure of how well a firm's managers may have estimated the lending risks they assumed. We suggest that the contractual interest income amounts be disclosed at each reporting period.

Also, we understand that the proposed guidance would allow firms with financial instruments presented on an FV-NI basis to separately present interest income on the statement of comprehensive income – without specifying a particular method of calculating interest income to be displayed in the statement of comprehensive income. We would prefer to see the standard contain guidance that will produce interest income consistently across all financial assets, whether they are carried on an FV-NI basis or an FV-OCI basis.

Overall, we believe that the methodology for recognizing interest income on financial instruments classified as FV-OCI will provide useful information to those FASB constituents who are most concerned with the preservation of the amortized cost model. We believe they should find it suitable to their needs, and that investors will be able to comprehend the information provided when credit loss allowance adjustments occur for differences between contractually due interest income and recognized interest income.

There are differences between the method of recognizing interest income for FV-OCI instruments proposed by the FASB and the IASB. While the timing is generally similar, we find that the FASB's method is more descriptive of events that have actually occurred, and less subjective than the IASB's recognition method which would include only management's perspective of expected future losses. We prefer the FASB's model. For a similar reason – a clearer portrayal of economic events – we agree that an entity holding financial instruments accorded an FV-OCI treatment should no longer accrue interest on them when the overall yield is expected to be negative.

Hedge Accounting

With all financial instruments reported at fair value, we hold that there is less need for specialized hedge accounting treatments. A full fair value balance sheet is effectively its own hedge. In that the hedged item and the hedging instrument are both reported at fair value, we believe that there will be a more transparent display of the activities occurring within the firm (the hedging activities) and the events occurring outside the firm that affect it (the effect of economic and market conditions on the values of those instruments). We support the modification of the effectiveness threshold from highly effective to reasonably effective. At the same time, however, we believe that when firms find it necessary to employ hedge accounting, and they have determined a hedge relationship is effective at the outset of a hedged transaction, the relationship should still be monitored for effectiveness in accordance with the proposed guidance.

Disclosures

We support the proposed disclosure requirements, including those related to purchased financial assets. We believe those particular disclosures will enable investors to better assess the effects of such purchased assets on the overall profitability of a firm. There are, however, several additional disclosures we would suggest:

1. Contractual interest income, as discussed under "Interest Income," above.
2. Assets by category, vintage and whether purchased or originated within each receivable type. (For example, construction & industrial, or residential real estate

and their year of origination.)

3. Loan loss reserves applied against each of the categories delineated in 2. (For example, x% against commercial real estate originated in 2005, y% against commercial real estate purchased in 2005, etc.)
4. Actual cumulative loss experience by category, vintage and origination method for the periods reported to date, and total cumulative losses.
5. Loan-to-value relationships and any other relevant underwriting criteria stratified by loan category at origination date and updated to the most current reporting period.
6. FICO scores
7. Interest rates at origination, interest rates currently and the impact of interest rate swaps.

Effective Date and Transition

We support the proposal's overall transition approach, including the delayed effective date for smaller nonpublic entities.

The ITAC appreciates this opportunity to provide its perspective to the Board and its staff on this exposure draft. Should you wish further clarification of our views, we would be pleased to respond.

Sincerely,

Investors Technical Advisory Committee
By:

Jack Ciesielski
Member