

May 15, 2013

Ms. Leslie Seidman  
Chairman  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

The Honorable Hans Hoogervorst  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London, EC4M 6XH  
United Kingdom

**Re: FASB Proposed Accounting Standards Update on *Financial Instruments – Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities***

Dear Chairmen Seidman and Hoogervorst:

The Financial Instruments Reporting and Convergence Alliance (“FIRCA”) is a coalition of business, financial, insurance and real estate trade organizations representing all sectors of the economy and areas of the financial services arena. FIRCA recognizes that accurate and transparent financial reporting is a cornerstone of our capital markets in the United States and globally.

FIRCA appreciates the opportunity to comment on the Financial Accounting Standards Board (“FASB”) Proposed Standards Update on ***Financial Instruments – Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*** (the “Proposal”). FIRCA believes that the Proposal can be improved by avoiding the unintended consequences and adopting the following recommendations:

- Financial instruments (when not held for trading purposes) should be recognized at fair value, including fair value with periodic changes in fair value recognized in other comprehensive income (“OCI”) (i.e., “FV-OCI”), or amortized cost based on the underlying business strategy for holding or

issuing the financial assets, which includes both the reporting entity's strategy for the financial assets as well as its business model;

- This principle should apply to equity securities and securitizations with multiple credit tranches that are not held for trading purposes;
- The Proposal appears to create a disincentive to invest in equity securities and securitizations with multiple credit tranches. We believe that the Proposal should avoid such an unintended consequence as it will drive economic activity, instead of reflect it, harming investors and businesses as a result;
- Application guidance on contractual cash flow characteristics assessment should not drive the determination of classification and measurement for debt instruments with criteria and conditions that undermine the overall principle and, thereby, lead to counter-intuitive results;
- Any application guidance for business model assessment should reflect economic activities and not be so restrictive as to undermine the alignment of the classification and measurement of debt instruments, in particular, with the reporting entity's underlying strategy for the financial assets as well as its business model;
- Hybrid assets with embedded derivatives should be bifurcated and reported separately using existing guidance;
- The fair value option should be available in situations where financial assets and liabilities are managed together on a fair value basis as well as to prevent an accounting mismatch;
- Disclosure guidance may benefit from reconsideration in light of the FASB's Disclosure Framework project.

Our concerns are discussed in greater detail below.

## **I. FIRCA Mission and Principles**

The mission of FIRCA is:

- To support the use of high quality, robust international accounting standards developed and adopted jointly by the FASB and International Accounting Standards Board (“IASB”). These standards should be decision-useful, reliable, and relevant. Additionally, these standards should present financial information in a manner that reflects the business operations of the reporting entity. Appropriately crafted standards should transparently provide information and not drive economic activity.
- To assist standard setters in providing a wide range of input to ensure the proper consideration of business operations and potential unintended consequences in the development and implementation of accounting standards.
- Recognizing the ongoing impacts of the 2008 financial crisis and continued currency pressures in the Euro Zone are global in scope and magnitude, we will continue to work with standard setters and decision makers to ensure that these projects are conducted jointly to provide a comprehensive response to financial reporting policies.

## **II. Comments on Proposal**

We recently provided you with FIRCA’s updated principles that cover several aspects of the joint Financial Instruments project including: Classification & Measurement of Financial Assets and Financial Liabilities, Impairment, Derivatives and Hedging.<sup>1</sup> We updated these principles to reflect changes in the market as well as progress made by the Boards in their deliberations.

Consistent with FIRCA’s principles, we support principles of classification and measurement that include fair value with periodic changes in fair value recognized

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<sup>1</sup> See FIRCA letter of October 10, 2012 to FASB Chairman Leslie Seidman and IASB Chairman Hans Hoogervorst. For convenience, FIRCA’s Core Principles are also included as an attachment to this letter.

through net income (“FV-NI”), FV-OCI, and amortized cost and the related requirement that when FV-OCI financial assets are derecognized the fair value gains or losses accumulated in OCI are reclassified (recycled) to net income. However, we are concerned that several aspects of the Proposal are inconsistent with FIRCA’s principles.

**a. Securitizations and Equity Securities**

The Proposal would require the classification and measurement of equity securities and most securitizations at fair value with periodic changes in fair value recognized through net income (i.e., FV-NI) rather than in OCI (i.e., FV-OCI). Consistent with our Core Principles for Classification & Measurement, FIRCA recommends that the FASB allow these financial instruments (when not held for trading purposes) to be at fair value, including fair value with periodic changes in fair value recognized in OCI (i.e., FV-OCI), or amortized cost based on the underlying business strategy for holding or issuing the financial assets, which includes both the reporting entity’s strategy for the financial assets as well as its business model.

In this regard, FIRCA is particularly concerned about application guidance for securitized financial assets. The Proposal includes conditions for when a beneficial interest in a securitized financial asset gives rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. All the conditions must be met, including:

- *The exposure to credit risk in the underlying pool of financial instruments that are inherent in the tranche of beneficial interest is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments. For example, this condition would be met if the underlying pool of instruments were to lose 50 percent as a result of credit losses and **under all circumstances** the tranche would lose 50 percent or less.* (ASC 825-10-55-26c)

As a result of this application guidance, any structured security where subordination is created in order to redistribute the credit risk to different note-holders (tranches) would be recorded at FV-NI, except for the most senior tranche.

As we have previously expressed,<sup>2</sup> FIRCA disagrees with the inclusion of this more restrictive application guidance in the Proposal. FIRCA believes this is wrong because:

- It is inconsistent with the principle that the accounting should follow the business model. In this case, it would treat securities held for long-term cash flows or for sale to be accounted for as if they were trading securities held for sale providing less transparency to investors;
- Payments to each tranche-holder represent payments of principal and interest from the underlying loans; and
- This results in the introduction of credit risk considerations into classification and measurement principles.

Accordingly, FIRCA recommends, consistent with our principles for classification and measurement, that the FASB allow securitizations with multiple credit tranches that are not held for trading purposes to be at fair value, including fair value with periodic changes in fair value recognized in OCI, or amortized cost. Again, this would be based on the underlying business strategy for holding or issuing the financial assets, which includes both the reporting entity's strategy for the financial assets as well as its business model.

More generally, the Proposal includes guidance on classification and measurement for equity instruments, whereby equities would be recorded as FV-NI, which is likewise inconsistent with FIRCA's principles. Financial assets that are not held for trading purposes (and are not debt instruments) should be permitted to be measured at fair value with period changes reflected in OCI, where amounts are recycled into net income upon being realized.<sup>3</sup> (This would likewise be based on the underlying business strategy for holding the financial assets, which includes both the reporting entity's strategy for the financial assets as well as its business model.)

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<sup>2</sup> See FIRCA letter of November 16, 2012 to FASB Chairman Leslie Seidman and FIRCA letter of March 25, 2013 to Chairman Hans Hoogervorst and Chairman Leslie Seidman.

<sup>3</sup> Although not the focus of the Proposal, but consistent with FIRCA's principles, since equity securities do not have an expected cash flow stream, impairments for equities occurs when it is expected the cost basis will not be recovered in a reasonable time period.

FIRCA's concerns about the Proposal on these matters also extend to their economic consequences. FV-NI would add volatility to net income. Thus, for example, the Proposal would adversely impact the marketability and liquidity of securitizations with multiple credit tranches, as this important asset class of securities would likely be less attractive to investors. Similarly, equity securities may be a less attractive investment given the potential volatility in net income could be viewed adversely by investors in entities that hold equities for purposes other than trading.

As FIRCA has previously noted,<sup>4</sup> the consequences of discouraging entities from investing in equity securities would likely include financial institutions. Recently, the G-30 expressed concerns about actions by regulators and standard-setters that would restrict the ability of financial institutions to invest in equity securities.<sup>5</sup> We believe that this is an unintended consequence of the Proposal and one that should be reviewed and considered by the FASB before finalizing the new standard. If the Proposal were to create a disincentive for investing in equity securities, the standard would drive economic activity rather than reflect it, harming investors and businesses in the process. We do not believe that is the FASB's intention, but one that should be investigated and corrected.

## **b. Application Guidance**

FIRCA is very concerned that the application guidance in the Proposal on contractual cash flow characteristics assessment will drive the determination of classification and measurement for debt instruments with criteria and conditions that undermine the overall principle related to contractual cash flows and, thereby, lead to counter-intuitive results. Examples of problematic criteria include ancillary income (ASC 825-10-55-16), matching timeframes for variable interest rate resets (ASC 825-10-55-18), and prepayment options (ASC 825-10-55-21). FIRCA believes that including criteria such as these for conditions that are common, for example in mortgages, will have significant unintended consequences and should be removed.

FIRCA is also concerned about application guidance for business model assessment, including guidance on concentration of credit risk to qualify for amortized cost (ASC 825-10-55-31). This application guidance is so restrictive, particularly for

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<sup>4</sup> See FIRCA letter of March 25, 2013 to IASB Chairman Hans Hoogervorst and FASB Chairman Leslie Seidman.

<sup>5</sup> See the G-30 report on *Long-Term Finance and Economic Growth* issued on February 11, 2013 that proposes financial regulatory reforms to address global long-term capital shortfalls.

Ms. Leslie Seidman  
The Honorable Hans Hoogervorst  
May 15, 2013  
Page 7

loans, as to undermine their classification and measurement from being consistent with a reporting entity's underlying strategy for the financial assets as well as its business model.

In this regard, the IASB's application guidance is much more aligned with FIRCA's core principles. For example, the IASB Exposure Draft on *Classification and Measurement: Limited Amendments to IFRS 9* (November 2012) includes guidance on considering the level of sales activity, as well as the reason for any sales, in determining whether cash flows are expected to be collected from contractual cash flows. In the IASB Exposure Draft, sales that occur for "other reasons" may also be consistent with a business model whose objective is to hold financial assets in order collect contractual cash flows if such sales are infrequent (even if significant) or insignificant both individually and in aggregate (even if frequent). Aligning FASB and IASB application guidance would have the added benefit of improving the convergence of U.S. Generally Accepted Accounting Principles ("US-GAAP") with International Financial Reporting Standards ("IFRS").

### **c. Other Comments**

In addition, FIRCA is concerned that the Proposal would require the classification and measurement of hybrid assets with embedded derivatives at FV-NI in their entirety. Consistent with FIRCA's principles, we recommend that hybrid assets with embedded derivatives should be bifurcated and reported separately using existing guidance. The remaining host should be measured considering the reporting entity's business strategy for the instrument (i.e., hold for collection or payment of cash flows or current settlement) and its business model.

FIRCA suggests a modification to the Proposal in regards to the fair value option for financial assets and financial liabilities. Consistent with FIRCA's principles, the fair value option should be available in situations where financial assets and liabilities are managed together on a fair value basis *as well as to prevent an accounting mismatch*. Inclusion of the latter is consistent with the IASB's guidance and so our suggestion would again serve to advance the convergence of US-GAAP and IFRS.

Finally, FIRCA suggests that the FASB may want to reconsider guidance on disclosures in the Proposal as the FASB's project on a Disclosure Framework evolves. In particular, that project may provide a more overarching determination for interim

Ms. Leslie Seidman  
The Honorable Hans Hoogervorst  
May 15, 2013  
Page 8

disclosures, especially under circumstances where quarterly disclosures would be substantially similar to the annual disclosures because no major changes have occurred.

### **III. Conclusion**

FIRCA looks forward to continuing our efforts to work with the FASB to achieve our goals of robust accounting standards that reflect the economic activity of business operations in the furtherance of efficient and fair global capital markets. We believe that our suggestions will improve the Proposal and help to achieve high quality global accounting. We stand ready to assist you in achieving these goals.

Sincerely,

American Council of Life Insurers  
Barnert Global, Ltd.  
CRE Finance Council  
Mortgage Bankers Association  
National Association of Real Estate Investment Trusts  
Structured Finance Industry Group  
The Financial Services Roundtable  
The Real Estate Roundtable  
The U.S. Chamber of Commerce