



May 15, 2013

Ms. Leslie Seidman
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-05116

Re: File Reference No. 2013-220: Financial Instruments - Overall (Subtopic 825-10)
Recognition and Measurement of Financial Assets and Financial Liabilities (the
"Proposal")

Dear Ms. Seidman:

The Clearing House Association L.L.C. ("The Clearing House"),¹ an association of major commercial banks, appreciates the opportunity to comment on the above-referenced Proposal released by the Financial Accounting Standards Board (the "FASB" or the "Board") for comment.

Executive Summary

The Clearing House supports classifying financial instruments based on a framework of an entity's business model, as well as the cash flow characteristics of the financial instruments. However, The Clearing House believes the Proposal does not improve existing U.S. generally accepted accounting principles ("U.S. GAAP") and therefore, recommends that the Board not proceed with the Proposal and instead maintain the existing U.S. accounting model. A few of The Clearing House's foreign banking organization members have advised that they generally support the Proposal as it would more closely align U.S. GAAP with the proposed International Accounting Standards Board (the "IASB") model on classification and measurement (November 2012, Classification and Measurement: Limited

¹ Established in 1853, The Clearing House is the oldest banking association and payments company in the U.S. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

Amendments to IFRS 9, Proposed amendments to IFRS 9 (2010) ("IFRS 9 ED" or "IASB model")) and thus they believe it would result in more comparability among issuers and provide a more reliable measurement model for financial instruments.

The Clearing House supports the efforts of the Board to simplify and provide more decision-useful information to investors. However, we believe the Proposal creates unnecessary complexity and does not improve the information disclosed to investors, thereby not achieving its main objective. Therefore, we see no compelling reason to change the existing U.S. accounting model.

In particular, we believe that the Proposal is flawed in the following two respects:

- The business model test as proposed will not produce more decision-useful information for a fairly common business model in the banking industry, that of originating loans for the purpose of either holding them to maturity or selling them from time to time. The business model criteria as proposed are inconsistent with this intended purpose of originating loans and are inconsistent with the way the industry manages loans subsequent to origination.
- The cash flow characteristics criterion ("the SPPI test") is overly complex and likely will require voluminous implementation guidance to make its application consistent and operational.

Another consequence of this Proposal is that more financial instruments, including loans, will be required to be measured at fair value. Feedback on the Board's previous proposal² indicated that most respondents did not support measuring more instruments at fair value.

In contrast to the Proposal, the accounting for classification and measurement of financial instruments under existing U.S. guidance is operational, non-controversial, and well-understood by financial statement users. It appears that implementation of the Proposal will be costly and likely will take several years; we do not believe those costs are justified in the absence of any real improvement in the U.S. accounting model.

The Clearing House does, however, support the proposed requirement to present separately in Other Comprehensive Income ("FV-OCI") the changes in instrument-specific credit risk for financial liabilities for which the fair value option has been elected. We believe this change will be less confusing to financial statement users, and result in more decision-useful information, as the impact of liability credit risk is routinely backed out of earnings and disregarded by investors and analysts. Accordingly, we recommend that the Board issue a limited scope proposal on this issue alone.

² Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)* – File Reference No. 1810-100, May 2010.

Should the Board decide to proceed with the Proposal in its entirety, The Clearing House believes it is crucial that the Board address the two flaws noted above. Specifically, The Clearing House:

- *strongly recommends* that the business model approach should explicitly recognize that an entity's strategy may require it to sell loans classified in amortized cost from time to time for various reasons, including, but not limited to, for credit risk management purposes or to exit a particular product or region. Regardless of the fact that sales may sometimes occur, all loans that were originated or purchased with the intent to collect contractual cash flows should be classified in amortized cost unless originated or acquired for purpose of sale. Once specific loans in amortized cost have been identified for sale, they should continue to be classified as amortized cost; however, this change in intent would require the entity to recognize impairment on those loans to the extent that the net realizable value of the loan(s) is less than the recorded investment;
- *recommends* prohibiting loans from being measured at fair value with qualifying changes recognized in FV-OCI, as we do not believe that classification is needed for loans; and
- *requests* that the embedded derivative guidance for financial assets be retained and used instead of the SPPI test. A financial instrument would be evaluated under the embedded derivative guidance, and embedded derivatives that are required to be bifurcated would be classified at fair value with changes recognized in net income ("FV-NI"). The remaining host instrument would be classified under the entity's business model. Alternatively, the hybrid instrument could be accounted for under the fair value option consistent with current accounting.

We also have a number of additional comments and suggestions. In summary, The Clearing House:

- *recommends* that the business model test be performed at the level at which asset management decisions are made, for example, at the portfolio or "desk" level;
- *recommends* that sales of securities out of the amortized cost category be permitted in certain additional circumstances;
- *recommends* that equity method investments be classified as FV-NI only if an entity intends to sell the investment, and that the concept of an investment being "available for exit" be removed, to avoid including in FV-NI those investments with a limited life that an entity does not intend to sell;
- *recommends* that fair value information and other details such as equity method investments held for sale and amortized cost assets subsequently identified for sale not be required to be presented on the face of the financial statements but rather allowed in the footnotes as an alternative; the Level 3 unobservable inputs used to determine the fair value of instruments carried at amortized cost should not be required to be disclosed as it is not relevant; and the disclosures regarding core deposit liabilities should be eliminated as many of these concepts are not clearly defined and certain information is proprietary in nature; and

- *believes* the fair value option has worked well in the past, best reflects how an entity manages its assets, and is not in need of revision. If amended, however, The Clearing House *suggests* the Board adopt the IASB's approach wherein the fair value option may be elected to eliminate or significantly reduce a measurement or recognition inconsistency that would otherwise arise from measuring financial instruments on different bases.

A detailed discussion of each point listed follows below.

A. The Proposed Model will Result in less Decision-Useful Information for Loans.

The Clearing House agrees in principle with a business model approach, wherein an entity would classify financial assets on the basis of how an entity expects to manage portfolios of assets to realize cash flows. We believe an entity's asset management decisions and the manner in which cash flows are expected to be realized are important to investors and the classification of assets on the balance sheet should convey this information.

The Clearing House also believes the three general categories -- financial assets measured at amortized cost; financial assets measured at FV-OCI; and financial assets measured at FV-NI -- are needed to reflect the diverse business strategies of a financial institution, and also provide for consistency in classification among organizations. However, we note that amortized cost remains the most relevant measure for portfolios of loans held for investment and managed for yield, as opposed to those managed for short-term profit, capital appreciation or capital returns.

In addition, while we appreciate the Board's desire to develop a single comprehensive model that would encompass both loans and securities, we believe it will be difficult to apply the Proposal to situations where an entity's business model is to originate or purchase loans, such as residential mortgage loans, with the possibility that it may sell some undetermined portion of the loans in the future. Under the current guidance, residential mortgage loans originated with the intent to sell or transferred to the held for sale classification are held at the lower of amortized cost or fair value, while other loans are measured at amortized cost until a decision has been made to market the loan for sale. Given the Proposal's strict limitations on reclassifications out of the amortized cost category, which today only apply to securities that are classified as held to maturity, the current accounting for loans held for sale would no longer be permitted if the Proposal is adopted due to its strong implicit tainting notion.

The Proposal states that when an entity engages in a held-for-sale business model, it should use its best estimate and classify a percentage of the pool of loans into one of the classification categories.³ While this approach might be feasible to apply to discrete pools of homogeneous loans, the application to the entirety of an entity's loan portfolio, given the diversity in the types of loans a financial institution typically holds, would not be feasible. When a loan in the pool is then specifically identified as "for sale," an entity would need to assume that the loan was in the percentage of loans held for sale, and then the remaining pool would need to be re-balanced for the remaining percentage of amortized cost

³ BC 191.

versus FV-NI. This concept will be difficult to apply in practice, and we believe it will also be confusing to investors.

We do not believe the solution is to classify all loans in the FV-NI category initially, because this would result in less decision-useful information for investors and would not convey the fact that a portion of the loans will in fact not be sold and will be held for the collection of contractual cash flows. Thus, while the Proposal appears to reduce complexity by reducing the number of accounting models, the Proposal would result in less useful information for a business model that is fairly common in the banking industry.

Accordingly, we recommend that, if the Board decides to proceed with the Proposal, the Proposal be modified so that the accounting model will accurately reflect to investors the way that an entity manages its loan portfolios.

The Clearing House recommends an approach where loans would be classified at amortized cost if management has no current intention to sell the loans. If management's intention changes, such that it has determined it intends to sell certain loans, the entity would then be required to recognize impairment on those loans to the extent that the net realizable value is less than the recorded investment. There would be no explicit or implicit tainting provisions relating to sales from the amortized cost category. Reclassifications from the amortized cost category to FV-NI would be expected to be rare and would be required to be disclosed

Consistent with the Proposal, originated or purchased loans that management intends to sell from the date of origination or acquisition would be initially classified as FV-NI. The FV-OCI category is, therefore, not needed for loans, and as a result, we recommend loans be prohibited from classification in the FV-OCI category.

B. The Proposed Cash Flow Characteristics Test will Introduce Significant Complexity; Embedded Derivative Guidance should be Retained Instead.

The Proposal is based on the principle that an entity would determine the classification and measurement of a financial asset upon initial recognition by first considering whether the contractual terms of the asset give rise on specified dates to cash flows that are solely payments of principal and interest ("SPPI") on the principal amount outstanding.

While the overall principle of the SPPI test seems straightforward on its face, we are concerned the test has the potential to become quite complex and burdensome in actual practice. This view considers both the application guidance proposed, as well as the variety of instruments and instrument structures that will need to be evaluated, such as different types of interest rates, rate reset provisions, prepayment and extension options, contingencies, and other features that are disregarded from a U.S. GAAP perspective today as they would have immaterial impacts on the instruments' fair value or cash flows.

This could prove to be the case in even the most common transactions, such as the purchase of a plain vanilla debt security in the secondary market. Since the Proposal defines “principal” as the amount transferred to the holder at *initial recognition*,⁴ if a financial instrument is purchased after origination, the definition of “principal” would include the premium or discount on the instrument. This means holders of the same instrument may reach different conclusions under the SPPI test, depending upon when they acquired the instrument. In particular, those entities that purchase the instrument after origination have a higher likelihood of not meeting the SPPI criterion versus those that purchase the instrument at or near origination.

Another difficulty in applying the SPPI test is presented in the guidance illustrating application of the criterion to Instrument B, the Variable Rate Instrument with a stated maturity date.⁵ The Proposal provides that the instrument meets the contractual cash flow characteristics criterion in the instance where the borrower can choose to pay either a three-month LIBOR rate for a three-month term or a one-month LIBOR rate for a one-month term. In contrast, the instrument may not meet the contractual cash flow characteristics criterion when the borrower is able to choose to pay a one-month interest rate that is reset every three months (comparison to the “benchmark instrument” would need to be performed to make a conclusive determination). The rationale provided is that the frequency of the reset does not match the period of time covered by the interest rate, such that the contractual term modifies the economic relationship. However, we note certain commonly used rates, such as the prime rate, are not specifically based on a time period. As a result, without additional application guidance, one could conclude all instruments based on the prime rate would fail to meet the SPPI test. Similar issues arise with loans that have interest rates that may be influenced by bank-specific factors, such as the use of an adjusted treasury rate.

In addition, it is difficult to reconcile the rationale for the example cited above with the rationale for Instrument C, the Interest-Rate-Capped Variable Rate Bond.⁶ The conclusion for this instrument is that the instrument meets the contractual cash flow characteristics criterion even though it has a combination of both a fixed interest rate and a variable interest rate. While we agree that capped rate variable instruments should pass the SPPI test, as they are typically simple debt instruments, we do not see a fundamental difference when comparing them to Instrument B. Ultimately, we are concerned with the potential that the Proposal’s core principle may be inconsistently applied in the implementation guidance and, as a result, it gives the impression that the guidance is rules-based.

Furthermore, in assessing whether an economic relationship is modified by a contractual term of an instrument, an entity is required to consider the cash flows of a comparable “benchmark instrument” that does not contain the modification. The benchmark instrument is defined as a contract of the same credit quality and with the same contractual terms, except for the contractual term under evaluation, and may be either an actual financial asset or a hypothetical financial asset.⁷ The entity must determine whether, under reasonably possible scenarios, the contractual cash flows over the life

⁴ 825-10-25-18.

⁵ 825-10-55-51.

⁶ 825-10-55-53.

⁷ 825-10-55-19.

of the instrument could be more than insignificantly different from the benchmark cash flows. If the entity makes the determination that such cash flows are more than insignificantly different, then the financial asset must be measured at FV-NI. We believe this test will require a significant amount of judgment and, in practice, may result in a large number of questions. For example, it is not clear how the evaluation of future cash flows is meant to be performed, with possibilities including Monte Carlo simulation, rate shock simulation, or other types of scenario analyses. In addition, we believe questions may arise with regard to determining the benchmark instrument, what constitutes a “more than insignificant” difference, and what constitutes a market interest rate, especially in times of economic crisis when rates tend to fluctuate.

Finally, we believe that applying the SPPI test to credit card reward programs may result in unintended consequences. It is common for credit card issuers to grant cardholders reward points when they use their credit cards to purchase goods and services. Cardholders can usually redeem those points for cash, merchandise or services. Cash rewards are typically payable by the card issuer/lender, while the issuer may contract with third parties to fulfill redemptions involving merchandise or services. As rewards received by the cardholder do not represent payments of principal or interest, any credit card loans outstanding under the underlying credit agreement with the cardholder/borrower would not satisfy the contractual cash flow characteristics criterion and, presumably, such loans would be required to be accounted for at fair value, with changes in fair value recognized in net income.

The above scenarios are just a few examples of issues The Clearing House has considered and given the number and complexity of financial instruments, these likely represent only a small portion of the questions that may arise if the Proposal is finalized as is. We believe the Proposal as drafted will lead to a host of unintended consequences, with many relatively straightforward and commonplace instruments being required to be classified as FV-NI for seemingly inconsequential features, even though the instruments are managed for the collection of cash flows. This would, in turn, lead to less decision-useful information for investors, as it will not reflect how an entity actually manages the instruments it owns. Thus, in order for these instruments to be properly classified in accordance with the entity’s business strategy, a voluminous amount of additional implementation guidance would be required.

However, we do note that similar questions have already been addressed via the embedded derivative bifurcation requirements in Subtopic 815-15, *Derivatives and Hedging—Embedded Derivatives*. Those requirements arose from the attempt to interpret a similar concept, namely, whether a feature is “clearly and closely related” to the host instrument. This principle also seemed fairly straightforward when introduced, yet gave rise to numerous implementation issues. While consideration could be given to simplifying the existing “clearly and closely related” assessment, especially with respect to embedded interest rate derivatives and contingent options, we believe the guidance is relatively well understood and applied consistently in practice.

Therefore, rather than eliminating the embedded derivative guidance for financial assets, we suggest that it be retained and used instead of the SPPI test. That is, a financial instrument would be evaluated under the embedded derivative guidance, and embedded derivatives that are required to be bifurcated would be classified in FV-NI; the remaining host instrument would be assessed under the entity’s business model test. This approach would avoid introducing additional complexity to the

accounting guidance. Furthermore, because the embedded derivative bifurcation requirements for hybrid financial liabilities are retained in the Proposal, applying the bifurcation test to assets would ensure that the treatment of assets and liabilities is symmetrical, and therefore eliminate any potential mismatches that would otherwise arise on the statement of financial position.

C. The Model for Beneficial Interests in Securitized Financial Assets is Overly Complex and Flawed.

For beneficial interests in securitized financial assets, the Proposal would require an entity to look through to the underlying pool of instruments in determining whether the tranche meets the SPPI test.⁸ If the Board decides to retain the SPPI test, we have the following additional concerns with respect to the beneficial interest requirements.

The proposed requirements are fairly complex from a technical perspective. For example, we are concerned the approach would be difficult to apply to mortgage-backed securities issued by government-sponsored entities and debt instruments issued by actively managed investment funds, such as mutual funds and money market funds, as it would require a detailed analysis of the collateral underlying each individual loan in the pool that backs the beneficial interest. In addition, the requirement that exposure to credit risk inherent in the tranche of beneficial interest must be equal to or lower than the exposure to credit risk of the underlying pool of financial instruments seems unduly onerous.⁹ For example, it is not clear why there is a specific threshold for credit risk for beneficial interests, while other types of debt securities, including high-yield instruments, are not subject to a similar test. We believe the assessment of expected credit loss should be addressed by the impairment standard for all financial instruments, including beneficial interests. Finally, we are concerned the “look-through” test would be overly burdensome from an operational perspective, as it may be significantly time-consuming and in some cases impossible to obtain the necessary information. It also will be challenging to apply the tests to underlying pools of assets, especially considering that loss and cash flow allocations in a securitization structure can change depending upon the performance of the asset pools (e.g., “turbo pay” provisions triggered by delinquency levels, etc.).

As noted above, we recommend existing guidance be retained regarding the bifurcation of embedded derivatives in financial assets, which includes beneficial interests. We believe the existing guidance would identify the types of financial assets that the Board intended to address and may identify some assets not specifically addressed by the Proposal. For example, Case X in ASC 815-15-55-224 addresses beneficial interests that could suffer principal loss due to changes in interest rates. We do not believe this type of instrument would be required to be classified in FV-NI under the Proposal as it is written; but it would be under our suggested approach.

⁸ 825-10-55-26.

⁹ 825-10-55-26C.

D. The Business Model Test should be Performed at the Same Entity Level at which Asset Management Decisions are Made.

We are concerned that the business model as proposed is unworkable, as it implies that the business model must be established at a fairly high level within an entity. To make the classification approach more operational and more reflective of actual business practices, we suggest the Proposal explicitly recognize that: (i) an entity might manage the same or similar assets through different business activities (currently, this is stated only in the Basis for Conclusions);¹⁰ (ii) there can be multiple business models used within an institution; and (iii) the business model test should be performed not at the segment level or reporting unit level, but at the level at which asset management decisions are made, for example, at the portfolio or “desk” level.

E. Sales of Securities out of the Amortized Cost Category should be Permitted in Certain Additional Circumstances.

As noted above in section A, we believe loans should be subject to a different classification model, whereby loans are either classified in FV-NI, if loans are originated or purchased with the intent to sell, or in amortized cost, if management has no current intent to sell the loans. Loans would be prohibited from classification in the FV-OCI category. If management subsequently makes a determination to sell loans classified in the amortized cost category, those loans would be measured for impairment based on estimated net realizable value. As a result, we believe that the restrictions on sales from the amortized cost category detailed in the Proposal should not apply to loans, and the following comments relate only to securities classified at amortized cost.

The Clearing House agrees that sales of securities out of the amortized cost category should be permitted only in certain specified circumstances. We recommend that, in addition to the circumstances noted in the Proposal, other instances should be expressly permitted. For example, sales should be allowed when an entity has verifiable concerns about significant deterioration in the issuer’s creditworthiness, as waiting until the deterioration actually occurs would often be too late to maximize collection of cash flows. Permitting an entity to factor in its expectation regarding future cash flows also better aligns the Proposal with the “current expected credit loss” approach in the FASB’s proposal on Credit Losses.¹¹ In addition, we disagree with the Proposal’s conclusion that sales of financial assets resulting from managing concentrations of credit risk would be inconsistent with the objective of amortized cost classification, as diversification of credit and avoidance of an undue concentration is a hallmark of maximizing collection of cash flows for a portfolio of debt securities.¹²

Moreover, we believe that if a regulator directs a particular financial institution (rather than all institutions supervised by the regulator) to sell or transfer debt instruments classified at amortized cost, those sales and transfers should be permitted, as we believe this is consistent with the concept of a sale

¹⁰ BC 103.

¹¹ Proposed Accounting Standards Update, *Financial Instruments – Credit Losses (Subtopic 825-15)*, File Reference 2012-260.

¹² 825-10-55-31.

made in response to a regulatory requirement and does not negate the institution's business objective to hold and collect.

We also note slight differences in the wording between the IASB's model and the Proposal on this issue. The IFRS 9 ED provides that sales out of the amortized cost category should be "infrequent", whereas the Proposal uses the term "very infrequent."¹³ The IASB's model further notes that "sales that occur for other reasons may also be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows if such sales are infrequent (even if significant) or insignificant both individually and in aggregate (even if frequent)."¹⁴ We suggest the Proposal conform to and adopt the IASB model's language in these two instances.

Finally, we strongly support the Board's conclusion that the Proposal should not contain an explicit tainting notion. We believe the consequences of sales that appear to be inconsistent with the general objectives and principle of holding to collect contractual cash flows are most appropriately dealt with by the exercise of professional judgment rather than establishing detailed rules in the accounting guidance.

F. An Equity-Method Investment should be Measured at FV-NI Only if the Entity Intends to Sell It.

The Proposal would require equity method investments to be subsequently measured at FV-NI if the investment is held for sale at initial recognition. The Proposal uses a broad definition of held for sale, in that it would include those equity method investments where the investor has defined the time at which it expects to exit the investment, or an exit mechanism otherwise exists.¹⁵ We believe this broader definition of held for sale may prove to be problematic for certain types of investments. The effect of this would be to require investments in limited life entities and investments in closed-end funds to be measured at FV-NI, even though the investor does not necessarily intend to sell the investment prior to the contractual termination date of the underlying investment.

The Basis for Conclusions seems to suggest that this guidance was introduced to eliminate optionality in accounting for those investments where the investor's intent was to sell the investment.¹⁶ Therefore, we suggest that the Board simplify its approach such that if an entity's intent is to sell the investment, it should be considered as "held for sale" and measured at FV-NI. Accordingly, we recommend that the concept of an investment being "available for exit" as articulated in paragraph 323-10-15-20(b) be eliminated.

¹³ IFRS 9 ED B4.1.3; ASC 825-10-55-32

¹⁴ IFRS 9 ED B4.1.3.

¹⁵ 323-10-15-20(b).

¹⁶ BC 32 and BC 33.

G. Certain Presentation and Disclosure Requirements should be Modified or Eliminated.

The Proposal would require public entities to parenthetically present fair value for items measured at amortized cost on the face of the statement of financial position. While we appreciate the Board's objective to provide both fair value and amortized cost information to investors, we do not believe the fair value information should be required to be on the face of the statement of financial position. When assets are not managed on a fair value basis, fair value information is not always immediately available for the press release, which is typically issued several weeks prior to the issuance of financial statements. As a result, the proposed requirement will place an undue burden on financial institutions to expedite the determination of fair values for instruments that are not managed on a fair value basis. Placing fair value information on the face of the statement of financial position may also prove confusing to investors, as they might interpret fair value as being the primary measurement attribute for the instruments in question. We therefore believe that disclosure in the footnotes should be permitted as an alternative.

Similarly, we believe the decision to present separately on the face of the statement of financial condition, both equity method investments that are held for sale and amortized cost assets subsequently identified for sale, should not be mandatory but should instead be left to the discretion of the individual entity, taking into account the overall materiality of the items. Disclosure of these items, however, should be required.

Additionally, we do not believe quantitative information regarding the Level 3 unobservable inputs used to determine the fair value of instruments carried at amortized cost should be required to be disclosed. Providing this information for instruments that are regularly measured at fair value (as required today) is reasonable, since those assumptions directly affect an entity's reported results. Providing the same information by class of financial instrument for which the primary measurement basis is not fair value diminishes the relevance of the existing disclosures and is inconsistent with the objective of the FASB's ongoing Disclosure Framework project to improve the effectiveness of disclosures by clearly communicating the information that is most important to users of each entity's financial statements.

It is also unclear as to whether the Proposal would require that an entity present each of the line items articulated in paragraphs 825-10-45-12 and 825-10-45-13 (interest income/expense, changes in expected credit losses, and realized gains and losses from sales or settlements) for financial instruments measured at amortized cost separately from those same line items for financial instruments measured at FV-OCI; or whether the instruments in the two categories could be combined for income statement presentation purposes. We recommend the latter approach, as we do not believe there is a strong demand from users for disaggregation of these income statement items by classification category.

Finally, we recommend eliminating the proposed disclosures for core deposit liabilities. We believe there will be significant challenges in defining what exactly a "core deposit" is, and determining an "all-in-cost-to-service" rate. In addition, in some cases, the weighted average cost to service and weighted average maturity is considered to be proprietary information. Furthermore, given that these

estimates and calculations will be highly judgmental in nature, we do not believe that they will be comparable across entities. Accordingly, we do not believe these disclosures are particularly useful for investors and we recommend that they be reconsidered if and when the Board decides to revisit the accounting for core deposit liabilities.

H. The Fair Value Option is not in Need of Improvement and should not be Amended.

The Proposal would eliminate the unconditional fair value option in existing U.S. GAAP with a more limited approach. We believe the fair value option has worked well in practice and when elected best reflects how an entity manages its assets. Accordingly, we do not see a compelling reason to restrict this option.

If the fair value option is restricted, we suggest the Board adopt the IASB model's approach wherein the fair value option may be elected if doing so eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases.¹⁷

However, if the Board decides to proceed with its proposed approach, we support the proposal to require a nonrecourse financial liability that is settled with only the cash flows from the related financial assets to be measured on the same basis as those assets.¹⁸ In the absence of a fair value option, this change will be necessary to reduce the accounting mismatch that would otherwise result and to properly reflect the economics of these transactions. In addition, we suggest that, if a nonrecourse liability is measured at fair value, an entity should be permitted to measure the financial assets that will settle the liability on the same basis, if the fair value of the liability is more observable.

I. In View of Proposed Changes to Regulatory Capital Requirements, the Proposal would result in Significant Unintended Consequences for Banks of All Sizes.

We are also closely following the interaction of this Proposal with that of proposed changes in bank capital requirements. Under the existing guidelines for regulatory capital calculations set forth by the U.S. banking agencies, unrealized gains and losses arising from Available-for-Sale ("AFS") securities and defined benefit pension obligations that are recorded in accumulated other comprehensive income are reversed out of the calculation of shareholders' equity in calculating regulatory capital (this reversal is commonly referred to as the "AOCI filter"). Under the three joint notices of proposed rulemaking (together, the "NPRs") initially issued on June 7, 2012 by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (together, the "Agencies") addressing proposed changes to their regulatory capital rules to implement Basel III capital requirements, the unrealized gains and losses on AFS securities (and hence, under the Proposal, instruments classified as FV-OCI) would be **included** in the calculation of shareholders' equity

¹⁷ IFRS 9, paragraph 4.1.5

¹⁸ 825-10-35-11.

in calculating regulatory capital.¹⁹ The Clearing House previously submitted numerous comment letters to international and domestic regulators regarding elimination of the AOCI filter, the most recent of which is a comment letter to the Agencies dated October 22, 2012.²⁰ Among other consequences as described therein, elimination of the AOCI filter would force banks to reduce their AFS portfolios of high-quality fixed-rate securities (Treasuries securities and agency and GSE debt obligations) that they hold to hedge interest rate risk arising out of fixed-rate liabilities (including deposits), and/or decrease their duration, which is contrary to sound prudential and risk management practices and would result in less effective hedging. Banks would also need to develop alternative hedging strategies to compensate for decreased effectiveness, which involve interest rate swaps, collars and floors that are more costly to implement. Further, reflecting increases or decreases in FV-OCI resulting from unrealized accounting “gains” or “losses” in regulatory capital would create inaccurate reports of actual capital strength based solely on interest rate movements, thereby (i) weakening the effectiveness of regulatory capital ratios as a realistic, appropriate and credible measure of financial strength, effectively understating or overstating the ratios regardless of any change in real risk and (ii) introducing substantial volatility into capital ratios as measures of capital, forcing banks to maintain capital ratios substantially above the levels that would otherwise apply after buffers, to avoid potential sanctions applicable to banks that fall into the buffer range.

Our recommendations to prohibit loans from classification as FV-OCI and to replace the SPPI test with the embedded derivative guidance will mitigate these unintended consequences.

J. The Potential Costs to Implement the Proposal Appear to be Significant and are not Justified.

We note that, while the Proposal requires that instruments be classified on a portfolio basis, an entity will nevertheless be required to determine the classification of its portfolios on an instrument-by-instrument basis, in light of the cash flow characteristics criterion. This will be the case even if the Board accepts our recommendation to adopt the embedded derivative bifurcation guidance instead of the SPPI test. Accordingly, the initial implementation of the Proposal will likely take several years, and may be operationally intensive and costly. In light of this, we do not believe that the significant potential costs of amending this topic, which is currently operational, non-controversial and well understood, are worth the benefits of amending it as proposed.

¹⁹ Agencies, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III – Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*, 77 Fed. Reg. 52,792 (Aug. 30, 2012); Agencies, *Regulatory Capital Rules – Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements*, 77 Fed. Reg. 52,888 (Aug. 30, 2012); Agencies, *Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rules; Market Risk Capital Rule*, 77 Fed. Reg. 52,978 (Aug. 30, 2012).

²⁰ See pages 9-16 for additional implications of the elimination of the AOCI filter. Available at <http://www.theclearinghouse.org/index.html?f=074450>.

Conclusion

The Clearing House believes that the Proposal does not accomplish the Board's goal of simplification with the introduction of the SPPI test, and the business model approach, as currently proposed, will not result in more decision-useful information for investors, especially in the case of loans. Accordingly, The Clearing House believes that the Proposal does not represent an improvement in financial reporting and, therefore, The Clearing House does not support issuance of the Proposal in its current form.

Thank you for considering our request and the comments provided in this letter. If you have any questions or are in need of any further information, please contact me at (212) 613-9883 (email: david.wagner@theclearinghouse.org).

Sincerely yours,



David Wagner
Executive Managing Director and
Head of Finance Affairs

cc: Ms. Susan M. Cospers
Technical Director
Financial Accounting Standards Board

Mr. Paul Beswick
Chief Accountant
Office of Chief Accountant
Securities and Exchange Commission

Mr. Craig Olinger
Acting Chief Accountant
Division of Corporation Finance
Securities and Exchange Commission

Ms. Kathy Murphy
Chief Accountant
Comptroller of the Currency

Mr. Robert Storch
Chief Accountant
Federal Deposit Insurance Corporation

Mr. Steven Merriett
Deputy Associate Director and Chief Accountant
Federal Reserve Board

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board

Ms. Teresa Polley
President and Chief Executive Officer
Financial Accounting Foundation

Mr. Jeffrey Diermeier
Chairman, Board of Trustees
Financial Accounting Foundation

Mr. John (JJ) Matthews, PNC Financial Services Group Inc.
Chairperson – Financial Reporting Committee
The Clearing House Association L.L.C.

Ms. Esther Mills
President
Accounting Policy Plus

Mr. Ryan Pozin
Assistant Vice President
The Clearing House Association L.L.C.