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Technical Director  
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Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116  
United States of America

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the FASB's Proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10)—Recognition and Measurement of Financial Assets and Financial Liabilities* and the *Proposed Amendments to the FASB Accounting Standards Codification* (together, "the Proposal").

We commend the FASB and IASB ("the Boards") for their attempts to reach a more converged recognition and measurement standard for financial instruments. We recommend the Boards continue to pursue convergence during re-deliberations. Although complete convergence may not be achieved, financial statement users will be able to evaluate global enterprises with significant portfolios of financial instruments more easily the closer the final standards are to one another.

We also recommend the Boards continue to work together to eliminate wording differences in areas where convergence is achieved. While the Boards may believe their respective words have the same meaning, such differences increase the likelihood of alternative interpretations developing in practice. Similarly, differences in the extent of implementation guidance in the final standards will create a risk of diversity. While inevitably there will be some differences, the more consistent the final standards are in wording and extent of implementation guidance, the greater the degree of convergence that will be achieved.

We support the FASB's proposed comprehensive framework for classifying financial instruments, which is not dependent on legal form. We agree that the primary drivers for how financial assets are classified and measured should be a company's business model for managing its financial assets, as well as the cash flow characteristics of the instruments. The accounting model should faithfully portray the economic consequences of transactions in the context of a company's business strategies and the nature of those financial instruments.

We agree with the three category approach for debt investments. It acknowledges the practical reality that a company may invest in debt instruments to generate yield but may also sell if the price is considered advantageous, or if it is necessary to periodically adjust or rebalance the company's net risk, duration, or liquidity position. In other words, there is a middle ground where both amortized cost and fair value information are relevant. This point has been supported by users in past outreach.

To make the approach more workable, we have certain recommendations for improvements. Our most significant observations concerning the Proposal are summarized below. We have expanded on these and responded to the specific questions raised in the Proposal in the appendices to this letter.



### ***Business model assessment***

We support the need for a business model assessment that focuses on the primary purpose for holding portfolios of financial assets and how those portfolios will be managed under the company's business model. Furthermore, we broadly agree with the business model criteria for classifying portfolios of financial assets in the amortized cost, fair value through other comprehensive income, and fair value through net income categories. However, we are concerned with the absence of clarity in the proposed guidance when there is uncertainty at inception about whether an instrument will be held or sold. We are also concerned about the overly restrictive guidance for the types of allowable sales from the amortized cost category.

Companies may not always know their intention for managing an individual asset immediately at initial recognition. This is especially true for financial institutions with large portfolios of loans where there is more than one business model (i.e., the institution both sells some loans and holds others for the collection of contractual cash flows) and at inception, they have not yet determined which business model applies at an individual instrument level. The fair value through other comprehensive income category is described as capturing those assets. However, the proposed guidance also states that if a company knows it might sell some financial assets in a pool of similar assets while holding the remainder for collection, it should classify a percentage of the portfolio into one of the three categories as appropriate. We recommend the FASB address this apparent inconsistency by allowing a reasonable period of time for companies to determine the appropriate business model for the cash flows during the subsequent periods rather than being locked in to an inappropriate model too early. We believe that the classification of the individual financial assets should be consistent with the primary business model of the portfolio in which they are managed.

With respect to financial assets classified at amortized cost, it appears that the FASB has carried forward the guidance related to subsequent sales from today's held-to-maturity guidance. We believe this creates a threshold for allowable sales from the amortized cost category that is too restrictive. Companies should be able to make risk management decisions in response to changing economic environments that necessitate significant sales that were not reasonably anticipated at inception, and the accounting should accommodate those uncertainties. Limiting sales to situations where a significant deterioration in credit risk for an individual asset has already occurred or to "very infrequent" circumstances, could inhibit sound business and risk management decisions for lending activities of financial institutions that today's accounting accommodates. We recommend a model closer to the IASB's approach to allowable sales, which appears more flexible and focuses on whether the sales are the result of no longer meeting the company's documented investment policy. That approach is preferable, because it provides companies the flexibility to respond to changes in the economic environment that were not reasonably anticipated at inception. Thus, rather than only being reactive to significant credit deteriorations in specific financial assets, companies can be responsive to changes in the credit risk profile of the portfolio (i.e., concentrations of credit risk), or to unanticipated changes in the economic environment that lead to changes in their investment policies.

### ***Cash flow characteristics assessment***

We agree with the need for a cash flow characteristics assessment and believe both the nature and extent of cash flow variability are relevant factors for determining the classification of a financial instrument. However, we believe that the Boards' solely payment of principal and interest approach is overly restrictive and would inappropriately preclude many financial assets from the amortized cost or fair value through other comprehensive income categories.

The contractual cash flows of many financial assets are often not "solely" payments of principal and interest due to the presence of miscellaneous embedded derivative features. Although these features are only expected to be triggered in unusual circumstances, they are considered substantive because they are included in the instrument to address specific situations that could arise in the future. Such features do not create concerns under current practice, as they are either clearly and closely related and/or immaterial if separated. Under the proposed approach, the cash flow characteristics



assessment focuses on whether the cash flow variability related to interest rate or credit risk for all reasonably possible scenarios will create more than an insignificant difference as compared to a theoretical benchmark instrument (the "modified economic relationship test"). Any level of variability due to factors unrelated to interest rate or credit risk is not subject to this test, but instead would cause the instrument to automatically fail the cash flow characteristics assessment. We do not support such a bright line test and recommend that if the contractual cash flows predominantly or substantially relate to principal and interest, the financial assets should pass the cash flow characteristics assessment and be eligible for the amortized cost or fair value through other comprehensive income categories. We do not believe that embedded features unrelated to interest rate or credit risk that are likely to have only a small effect on cash flows or that are unlikely to arise in the future should drive the classification of a financial asset. Further, the consequences of failing to identify potentially insignificant features that are not considered solely the payment of principal and interest is harsh, given its potential dramatic effect on the instrument's classification.

Similarly, for beneficial interests, we believe that an insignificant level of "problematic" features or instruments in the underlying pool of assets should not negatively impact the ability of the investor to classify the beneficial interest at amortized cost or fair value through other comprehensive income. Further, consistent with IFRS 9, we recommend that collateral on financial instruments temporarily held within the pool be ignored for purposes of assessing the classification of the beneficial interest. In addition, when other instruments that do not meet the cash flow characteristics test are similarly obtained and held temporarily, for example, equity investments obtained in a restructuring of a debt investment, we believe these assets should not impact the investor's initial classification.

Another area of concern under the cash flow characteristics assessment relates to the proposed guidance for prepayment and extension options. US GAAP and IFRS have different accounting models for prepayment and extension options. Therefore, incorporating the IFRS guidance into US GAAP as proposed would represent a significant change in practice. Contractual terms that are commonplace in the US and not considered problematic under today's guidance may cause the financial asset to be measured at fair value through net income under the Proposal. We generally believe that today's US GAAP guidance on prepayment options is sound and more relevant for the US markets than the proposed guidance, although some improvements could be made. In particular, only applying the "double-double" test under reasonably possible scenarios, as opposed to all possible scenarios, would be a welcome improvement. It would also be consistent with the approach under the Boards' proposed modified economic relationship test for cash flow variability due to interest rate and credit risk.

### ***Fair value option***

We believe the ability to carry any financial asset or financial liability at fair value with changes in fair value recognized in net income is important, particularly for financial institutions that manage certain instruments on a fair value basis or for companies that wish to avoid the challenges of applying hedge accounting. Disclosures that enable financial statement users to understand a company's reasons for electing the fair value option continue to be an essential part of the fair value option. We are concerned that the proposed limited fair value option does not contemplate many situations where accounting mismatches could arise or fair value measurement would be preferable to financial statement users. Therefore, we continue to see the need for an unrestricted fair value option for both financial assets and financial liabilities. However, we do agree that when the fair value option is elected for financial liabilities, changes in fair value that are due to a company's own credit risk should be recognized in other comprehensive income if it does not create a measurement mismatch.

### ***Equity investments***

Applying the cash flow characteristics assessment under the proposed model will result in all equity investments being classified in the fair value through net income category. This is an area where the Boards are not converged. Our outreach indicates that many investors prefer to maintain at least a fair value through other comprehensive income category for certain investments, for example an investment in a static bond mutual fund. IFRS 9 contains an irrevocable fair value through other comprehensive income election for equity investments, and we encourage the FASB to further



consider such a classification under US GAAP. However, as we indicated in our response to the IASB's exposure draft, we would insist on the need for fair value changes to be recycled to net income upon derecognition of the investment.

We disagree with the FASB's proposed changes to the equity method of accounting and recommend the current US GAAP guidance, including the fair value option, be retained for these investments. We are also concerned that the held-for-sale criteria may be interpreted too broadly and inappropriately scope in certain investments. For example, investments in finite lived entities may be viewed as held-for-sale, because they have a definitive liquidation date. Further, the IASB is not addressing the equity method of accounting within this project, and the proposed changes would increase the number of differences in this area. Thus, in the absence of addressing the model holistically, we prefer the FASB retain current guidance on equity method accounting.

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If you have any questions, please contact Paul Kepple at (973) 236-5293, John Althoff at (973) 236-7021, or Chip Currie at (973) 236-5331.

Sincerely,

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

PricewaterhouseCoopers LLP



## **Appendix A - Responses to Questions for Respondents contained in the Proposal**

### ***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?***

Generally, we agree with the scope of the Proposal.

While we agree that investments in FHLB and Federal Reserve stock held by depository and lending institutions should be excluded from the proposed model, other types of institutions may also hold these or similar investments. For example, insurance companies also participate in the FHLB system. We recommend the FASB provide additional accounting guidance for other institutions that may hold similar investments.

### ***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 retaining industry-specific accounting guidance in the Proposal. That guidance has evolved over time to meet the needs of financial statement users in these industries, and we believe it should continue.

We note that while investment companies are scoped out of the initial and subsequent measurement guidance for debt and equity securities, no mention is made about other financial assets such as loans. Some investment companies, like Business Development Corporations, originate loans and measure them at fair value through net income in accordance with industry-specific guidance. We believe all investments held by investment companies should be excluded from the scope of the Proposal.

### ***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 with the need for a cash flow characteristics assessment and believe both the nature and extent of cash flow variability are relevant factors for determining the classification of a financial instrument. However, we believe that the Boards' solely payment of principal and interest approach is overly restrictive and would inappropriately preclude many financial assets from the amortized cost or fair value through other comprehensive income categories.

The contractual cash flows of many financial assets are often not "solely" payments of principal and interest due to the presence of miscellaneous embedded derivative features. Although these features are only expected to be triggered in unusual circumstances, they are considered substantive, because they are included in the instrument to address specific situations that could arise in the future. Such features do not create concerns under current practice, as they are either clearly and closely related and/or immaterial if separated. Under the proposed approach, the cash flow characteristics assessment focuses on whether the cash flow variability related to interest rate or credit risk for all reasonably possible scenarios will create more than an insignificant difference as compared to a theoretical benchmark instrument (the "modified economic relationship test"). Any level of variability due to factors unrelated to interest rate or credit risk is not subject to this test, but instead would cause the instrument to automatically fail the cash flow characteristics assessment. We do not support such a bright line test and recommend that if the contractual cash flows predominantly or substantially relate to principal and interest, the financial assets should pass the cash flow characteristics assessment and be eligible for the amortized cost or fair value through other comprehensive income categories. We do not believe that embedded features unrelated to interest



rate or credit risk that are likely to have only a small effect on cash flows or that are unlikely to arise in the future should drive the classification of a financial asset. Further, the consequences of failing to identify potentially insignificant features that are not considered solely the payment of principal and interest is harsh, given its potential dramatic effect on the instrument's classification.

Similarly, for beneficial interests, we believe that an insignificant level of "problematic" features or instruments in the underlying pool of assets should not negatively impact the ability of the investor to classify the beneficial interest at amortized cost or fair value through other comprehensive income. Further, consistent with IFRS 9, we recommend that collateral on financial instruments temporarily held within the pool be ignored for purposes of assessing the classification of the beneficial interest. In addition, when other instruments that do not meet the cash flow characteristics test are similarly obtained and held temporarily, for example, equity investments obtained in a restructuring of a debt investment, we believe these assets should not impact the investor's initial classification.

Another area of concern under the cash flow characteristics assessment relates to the proposed guidance for prepayment and extension options. US GAAP and IFRS have different accounting models for prepayment and extension options. Therefore, incorporating the IFRS guidance into US GAAP as proposed would represent a significant change in practice. Contractual terms that are commonplace in the US and not considered problematic under today's guidance may cause the financial asset to be measured at fair value through net income under the Proposal. We generally believe that today's US GAAP guidance on prepayment options is sound and more relevant for the US markets than the proposed guidance, although some improvements could be made. In particular, only applying the "double-double" test under reasonably possible scenarios, as opposed to all possible scenarios, would be a welcome improvement. It would also be consistent with the approach under the Boards' proposed modified economic relationship test for cash flow variability due to interest and credit risk. Additionally, we believe that extension options are analogous to prepayment options. Therefore, we recommend that the guidance for extension options be consistent with our preferred approach for prepayment options as described above.

Finally, we note that the cash flow characteristics assessment is only performed at initial recognition. The proposed guidance suggests that the concept of initial recognition should be viewed broadly and refers to obtaining an asset or liability. However, we recommend that the FASB clarify whether the cash flow characteristics assessment should also be performed when changes in the terms of the instrument occur. For example, a subsequent modification of the contractual terms of an instrument may change whether it meets the cash flow characteristics criterion. Provided the modification does not result in derecognition of the instrument, the Proposal does not require a reassessment of the contractual cash flows. We recommend that in the event of a modification to the terms of an instrument, a reassessment should be required to appropriately reflect the economics of the instrument in light of the modification.

***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?***

Concerns regarding the definition of principal primarily arise due to the proposed use of the IFRS approach for assessing prepayment options. It is not uncommon for a debt instrument to be prepayable at the option of the borrower at par, even though it was issued or acquired at a discount. Under current US GAAP, the prepayment option does not require separation, because it is the borrower's election to prepay at the higher par amount. However, under the Proposal instruments issued or acquired at a significant discount and that are prepayable at par will fail the cash flow characteristics test, as the strike price of the option is not deemed to represent unpaid amounts of principal and interest (i.e., does not approximate the amortized cost of the instrument).



We recommend that the FASB address this issue by retaining the current guidance in US GAAP for prepayment and extension options. If it does not, we recommend the definition of principal be revisited in an effort to address this issue. Regardless of the approach, we do not believe that debt instruments that were issued or acquired at a discount and that are prepayable at par at the discretion of the borrower should cause the instrument to fail the cash flow characteristics assessment. Similarly, debt investments that are issued at par and prepayable at a discount at the discretion of the lender should not cause the instrument to fail the cash flow characteristics assessment.

In addressing the definition of principal, we encourage the FASB to also reconsider the definition of interest. The determination of an interest rate typically involves consideration of a number of factors and is not limited to only what is needed to compensate the lender or investor for the time value of money and credit risk of the borrower or issuer. While the Proposal acknowledges that liquidity could affect the interest rate, we note that other factors also often influence the pricing of instruments, such as the borrowing costs of the lender, the cost of servicing, premiums associated with any embedded interest rate caps/floors, and prepayment options. We recommend the FASB conduct additional research into the types of features found in practice that may impact the interest charged on a debt instrument, so as to ensure its definition of interest is not overly restrictive.

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

The Proposal contains helpful application guidance and illustrations on implementing the cash flow characteristic assessment in certain specific scenarios. However, given the broad reach of the project there may be other instruments/transactions that are impacted by the Proposal for which further guidance should be provided. One such area relates to credit cards. These can be complex arrangements that involve rewards programs, interchange fees, rebates, late charges, and co-branding programs. Under today's accounting, many of these features are treated as separate units of account and thus would not appear to affect the application of the Proposal to the credit card receivable. However, it may be less clear how certain of these features, such as the rewards programs, should be treated when implementing the cash flow characteristics assessment. Given the complexity of these arrangements and the prevalence of credit card portfolios, we recommend the FASB research this area and consider the need to clarify the guidance.

Additionally, it is unclear how this Proposal will interact with the new revenue recognition model, specifically in areas such as volume discounts, rebates, early pay programs (for example, a supplier offers a 2% discount if the invoice is paid within 10 days instead of the full 30 day term) and co-operative advertising agreements. We recommend the FASB perform further research on this topic and consider the need to clarify the guidance.

***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?***

The "modified economic relationship test" appears helpful in that it provides a structured approach to assessing instruments with variable cash flows. However, as discussed in our response to Question 4, we recommend the FASB further consider how the "modified economic relationship" test should be applied.

In addition, we recommend changing the threshold terminology when assessing modified economic



relationship to be based on "significant" as opposed to "more than insignificantly different." We understand that "significant" translates better in other territories and therefore recommend it be used in both the FASB and IASB models.

Another area of concern that potentially arises with respect to the modified economic relationship test involves constant maturity instruments. These instruments typically contain an interest rate reset feature that is based on the rate associated with the original term of the instrument and not the length of the reset period. Depending on the interest rate environment and the reset feature, we believe that many of these instruments may not pass the modified economic relationship test. However, we don't believe that all of these instruments should necessarily fail this test, especially in circumstances where there are limited market interest rate indices available. Therefore, we recommend that if such a reset rate represents the only permitted pricing basis available for this type of instrument in a particular jurisdiction and the underlying economics of the instrument are structured to otherwise compensate for the time value of money and the credit risk of the borrower, the instrument should be eligible for the amortized cost or fair value through other comprehensive income categories.

Similar to constant maturity securities, concerns have been raised about the use of the "prime" interest rate. Debt instruments, including many adjustable rate mortgages, are indexed to the prime rate posted by the lending institution. However, the prime interest rate is not linked to a particular time period, and therefore, the same rate is used to adjust the interest on a debt instrument with one year left to maturity, as for an instrument with ten years left. Clearly the intent of the parties is for the instrument to only compensate for the time value of money and credit risk. But some have questioned whether the use of the prime interest rate could be construed to run afoul of the Proposal's guidance, because the same rate will be applied upon reset regardless of the remaining term of the instrument. Thus, debt instruments indexed to the prime interest rate may fail to pass the modified economic relationship test. Accordingly, we recommend the FASB clarify the guidance to accommodate debt instruments indexed to the prime interest rate.

Further, the use of the term "modified economic relationship" may lead to confusion. Under current GAAP, preparers and users associate a modification with a subsequent change to the terms of an agreement. As this is not the FASB's intention, we recommend that alternative language be considered when referencing this test.

***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?***

We agree with the application guidance provided. However, as discussed in our response to Question 4, we recommend that the FASB further consider how the "modified economic relationship" test should be applied. Refer also to our response to Question 7.

***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 believe that applying a look-through approach will be operationally challenging for companies to perform. However, we believe that it could be made more workable by allowing the same level of accommodation as proposed under the modified economic relationship test. Consistent with our recommended approach for assessing features that are not interest and credit related (see our response to Question 4), we believe that an "insignificant" level of "problematic" features or instruments in the underlying pool should not negatively impact the ability of the investor to classify



the beneficial interest in the amortized cost or fair value through other comprehensive income categories.

We further believe that, consistent with IFRS 9 (B4.1.26), collateral on financial instruments within the pool should be ignored for purposes of assessing the classification of the beneficial interest. Therefore, when collateral that does not meet the cash flow characteristics criterion is held or could be held within the pool due to a credit event, the classification of the beneficial interest should not be affected. Similarly, if other instruments that do not meet the cash flow characteristics assessment could be obtained and held temporarily (for example, equity investments obtained in a restructuring), these instruments should not impact the investor's initial classification.

The term "beneficial interest in securitized financial assets" has not been defined in the Proposal, and is not linked to the master glossary definition. IFRS 9 applies the same guidance to instruments that meet the definition of contractually-linked. Accordingly, we believe that certain instruments will potentially be assessed differently under the FASB and IASB's respective models. For example, we understand that single tranche investments are not considered to fall within the contractually linked guidance in IFRS 9. We recommend the FASB consider these differences and clarify the scope of its proposed guidance for beneficial interests.

In assessing whether the credit risk of the beneficial interest is equal to or lower than the credit risk of the underlying asset pool, an example is provided in paragraph 825-10-55-26c stating that if credit losses are fifty percent, then the tranche must lose fifty percent or less in order to be eligible for the amortized cost or fair value through other comprehensive income categories. If that example is read literally such that if credit losses are 80%, the tranche must lose 80% or less to qualify, then no tranches below the most senior would meet this requirement. We do not believe that this was the Boards' intention and accordingly, recommend that the example be clarified or removed.

***Question 10: Do the proposed amendments appropriately convey the principle associated with the business model assessment? If not, why? What would you propose instead?***

We support the need for a business model assessment that focuses on the primary purpose for holding portfolios of financial assets and how those portfolios will be managed under the company's business model. Furthermore, we broadly agree with the business model criteria for classifying portfolios of financial assets in the amortized cost, fair value through other comprehensive income, and fair value through net income categories. However, we are concerned with the absence of clarity in the proposed guidance when there is uncertainty at inception about whether an instrument will be held or sold. We are also concerned about the overly restrictive guidance for the types of allowable sales from the amortized cost category.

Companies may not always know their intention for managing an individual asset immediately at initial recognition. This is especially true for financial institutions with large portfolios of loans where there is more than one business model (i.e., the institution both sells some loans and holds others for the collection of contractual cash flows), and at inception, they have not yet determined which business model applies at an individual instrument level. The fair value through other comprehensive income category is described as capturing those assets. However, the proposed guidance also states that if a company knows it might sell some financial assets in a pool of similar assets while holding the remainder for collection, it should classify a percentage of the portfolio into one of the three categories as appropriate. We recommend the FASB address this apparent inconsistency by allowing a reasonable period of time for companies to determine the appropriate business model for the cash flows during the subsequent periods rather than being locked in to an inappropriate model too early. We believe that the classification of the individual financial assets should be consistent with the primary business model of the portfolio in which they are managed.



With respect to financial assets classified at amortized cost, it appears that the FASB has carried forward the guidance related to subsequent sales from today's held-to-maturity guidance. We believe this creates a threshold for allowable sales from the amortized cost category that is too restrictive. Companies should be able to make risk management decisions in response to changing economic environments that necessitate significant sales that were not reasonably anticipated at inception, and the accounting should accommodate those uncertainties. Limiting sales to situations where a significant deterioration in credit risk for an individual asset has already occurred or to "very infrequent" circumstances, could inhibit sound business and risk management decisions for lending activities of financial institutions that today's accounting accommodates. We recommend a model closer to the IASB's approach to allowable sales, which appears more flexible and focuses on whether the sales are the result of no longer meeting the company's documented investment policy. That approach is preferable, because it provides companies the flexibility to respond to changes in the economic environment that were not reasonably anticipated at inception. Thus, rather than only being reactive to significant credit deteriorations in specific financial assets, companies could be responsive to changes in the credit risk profile of the portfolio (i.e., concentrations of credit risk), or unanticipated changes in the economic environment that lead to changes in their investment policies.

We also disagree with the language in paragraph 825-10-55-78, Example 6: Held-to-Collect Contractual Cash Flows, which states that "If the entity is required by its regulator to sell financial assets either to demonstrate that the assets are liquid or to comply with a regulatory requirement that affects the entity (and not the industry) consistent with paragraph 825-10-55-32(d), the business model for those financial assets is not to hold them to collect contractual cash flows." While we understand how periodic sales to demonstrate liquidity are inconsistent with the amortized cost business model, it is not clear why a distinction is made for entity-specific regulatory requirement sales, and how an entity would know at inception that it may be forced to sell specific assets held at amortized cost on an individual and not an industry-wide basis. Given the breadth of powers that are often vested in regulatory bodies to protect the safety and soundness of the financial system, it could be argued that no entity subject to regulatory oversight may qualify for the amortized cost category. We believe this was not the FASB's intent and recommend that this guidance be clarified or removed, as the assessment of such sales at inception would seem to automatically preclude the amortized cost category for all companies subject to regulatory oversight.

***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?***

As noted in our response to Question 10, we believe that further clarity is needed on how the criterion should be applied to portfolios of assets (in particular loans) where a company has more than one business model, and at inception it has not yet determined which business model would be applied to a specific instrument. Our response to Question 10 also describes concerns about the allowable sales guidance, as well as the example when an entity could be required by its regulator to sell financial assets.

As noted in our response to Question 6, it is unclear how the Proposal will apply to credit card receivables. Certain credit card receivables may be part of a co-branding relationship, where it is management's intent to hold to collect contractual cash flows. However, if the co-branding relationship ceases, the receivables are generally sold to the co-branding entity at book value. As the receivable is contingently callable by the co-branding partner, some have questioned whether it could be considered held in a business model to collect the contractual cash flows. We recommend that the FASB clarify the guidance for sales out of amortized cost in these types of scenarios.



***Question 12: 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?***

As noted in our response to Question 10, we are concerned with the restrictive guidance on sales out of amortized cost. If the FASB considers a less restrictive amortized cost category, then we do not believe that the model should contain an explicit tainting notion. Sales in response to reasonably unanticipated changes in the economic environment should not preclude similar assets from being classified and measured at amortized cost in the future. However, if the FASB maintains the Proposal's restrictions on sales out of the amortized cost category, companies may find themselves in a position where their initial classification is brought into question following subsequent sales that occur in response to the changing economic environment. Such sales could be viewed as evidence that the original classification was incorrect. We do not believe that this was the FASB's intent, but the Proposal is unclear in this regard. We believe that applying a tainting notion in this circumstance would be preferable to concluding that prior period financial statements were in error.

We believe that the threshold for allowable sales from the amortized cost category is too restrictive and should not be limited to situations where a significant deterioration in credit risk for an individual asset has already occurred or to sales in "very infrequent" circumstances. While this threshold has historically existed for debt securities classified as held-to-maturity, we are concerned that it could inhibit sound business and risk management decisions for lending activities that today's accounting accommodates. Refer to our response to Question 10.

***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 agree that loan commitments, revolving lines of credit, and commercial letters of credit should be measured based on the likelihood of exercise and the classification of the underlying loan upon exercise of the commitment. However, we continue to believe that an unrestricted fair value option should be available, including for these instruments.

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

Generally we agree that initial measurement should depend on how that asset will subsequently be classified and measured (i.e., at transaction price for instruments in the amortized cost and fair value through other comprehensive income categories, and at fair value for instruments in the fair value through net income category). We also agree that investments should be assessed to determine whether the consideration given or received suggests that there is another element to the transaction that needs separate accounting.

However, we do not agree with the FASB's decision noted in BC 155 to distinguish between off-market rates given to a specific borrower versus a broad population of borrowers. We believe that the economics and business reason behind offering an off-market rate are the same whether given to a group of borrowers or a specific borrower. Therefore, we believe it is preferable for all lending arrangements other than those classified at fair value through net income be recorded at the transaction price, unless there is a separately identifiable element or transaction that requires recognition.



We generally agree with the Boards overall premise that financial assets in the amortized cost category and financial assets in the fair value through other comprehensive income category should have the same interest income recognition. However, the Proposal seems to contradict that notion as it relates to transaction costs. In particular, the basis for conclusion (BC 157) suggests that transaction costs that do not constitute loan origination fees or direct loan origination costs (and issuance costs for financial liabilities) should be expensed. We believe that transaction costs for all financial assets measured at amortized cost and fair value through other comprehensive income should be deferred and recognized as a yield adjustment in a manner similar to loan origination costs.

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

We believe a mixed measurement model should apply to financial liabilities, which is broadly consistent with what we have today. There is no need to make significant changes at this time.

In addition, we believe an unrestricted fair value option should continue to be available for financial liabilities. We are concerned that the limited situations where fair value measurement would be required for financial liabilities and the limited fair value option would be insufficient to address situations where asymmetrical accounting may otherwise arise. For example, for certain consolidated variable interest entities where there is recourse to the reporting entity, even when the assets may be at fair value, the liabilities may not be eligible for fair value measurement under the Proposal, and a measurement mismatch would arise in the absence of a fair value option. Furthermore, it is not uncommon for companies to elect the fair value option in lieu of applying the complex guidance for hedge accounting.

***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?***

We agree with the objective of this guidance—to help prevent measurement mismatches that cause uneconomic volatility in net income. We agree that the classification (i.e., fair value through net income, fair value through other comprehensive income, or amortized cost) of the financial liability should follow that of the financial asset. However, we question whether it is always appropriate for the measurement of the financial liabilities to follow the measurement of the assets, when the classification is fair value. If the fair value measurement of the financial liability will be more observable than the financial asset, we believe the measurement of the financial asset should follow that of the financial liability.

Further, additional clarity is needed on how the non-recourse financial liability guidance should be applied. For example, it is unclear if the presentation of changes in the measurement of the financial assets and related financial liabilities should be shown gross or net in the financial statements, how the financial liabilities should be measured when the related assets are on a mixed measurement basis, how to allocate the measurement amounts when there are multiple classes of financial liabilities, and how to account for non-recourse debt that contains embedded derivatives requiring separate accounting. It is also unclear how "non-recourse financial liability" should be interpreted. For example, whether some level of recourse is acceptable, such as would occur on breach of standard representations and warranties, and whether the non-recourse feature is only considered in relation to the reporting entity and not to third party guarantors.



***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 agree that financial assets measured at amortized cost that are subsequently identified for sale should continue to be classified and measured at amortized cost less impairment, with no gain recognized until sale occurs.

We note that the Proposal also requires these financial assets to be carried at fair value when fair value is less than the carrying amount. However, it is unclear how any previously recognized impairment should be treated if a company subsequently decides that it will not sell those financial assets. We recommend the guidance address whether any previously recognized impairment should be reversed, and whether such financial assets would then be reclassified for presentation together with other amortized cost assets not previously held for sale.

***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 commend the FASB for providing a practicability exception for equity investments without readily determinable fair values and have encouraged the IASB to provide the same accommodation. We further agree that it should be available to all companies that hold equity investments without readily determinable fair values. The practicability exception acknowledges the challenges companies continue to encounter in determining fair value, especially in situations where there is an absence of valuation information available on a timely basis. Allowing a practicability exception will provide preparers relief from making difficult and highly subjective fair value estimates each reporting period, yet helps to ensure that changes in fair value are recognized when there is clear evidence of a change or impairment.

***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 agree that the valuation allowance should be analyzed separately for financial assets measured at fair value through other comprehensive income. It appears that by not requiring entities to assess these deferred tax assets for realization based upon expected future taxable income, they would not require a valuation allowance, even if all other deferred tax assets are not considered realizable because of a lack of expected future taxable income. This is inconsistent with Topic 740, which currently requires companies to consider the expected realizability of a deferred tax asset (i.e., the extent to which the deferred tax asset is expected to result in a reduction of taxes payable or an increase in taxes refundable) as opposed to its mere reversal. Further, the proposed accounting may not appropriately portray the economics of the tax consequences of these instruments.

Notwithstanding our comments above, if the FASB decides to proceed with the current proposal, we recommend the standard provide further guidance on how to separately assess the related deferred tax asset. As currently written, the Proposal does not distinguish between financial assets for which



management has the intent and ability to hold until recovery of the current unrealized losses and those that management might be willing to dispose of prior to maturity or recovery. Further, under the proposed accounting model, it is unclear whether taxable temporary differences related to unrealized gains on financial assets that are measured at fair value through other comprehensive income and expected to be held to maturity should continue to be, or should no longer be, treated as potential sources of future taxable income in assessing the realizability of deferred tax assets, including those not recorded through other comprehensive income.

Finally, while we disagree with the concept of separately evaluating the need for a valuation allowance in these cases, there are occasions where that would be appropriate and necessary. For example, an entity may have a deferred tax asset for an unrealized loss on a financial instrument that would become a capital loss if realized in a tax regime in which capital losses may only be offset against capital gains. In that instance, we believe it would be necessary to evaluate the realizability of the embedded future capital losses in a manner that considers the characteristics of the entity's future taxable income. In particular, in the absence of prudent and feasible tax-planning strategies, an entity would not be able to avoid a valuation allowance if the entity believes it is more likely than not that there will be future taxable income on an aggregate basis but is unable to reach such a conclusion with regard to future capital gains. However, in our opinion, this example represents one of only a limited number of cases in which such distinct consideration should be made, rather than a general requirement to separately assess realizability as is proposed.

***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 generally agree with the proposed approach to hybrid financial assets. However, as discussed in our response to Questions 4 and 7, we believe that any feature that results in cash flows that are insignificantly different than an instrument without that feature should not affect the eligibility of that instrument for the amortized cost or fair value through other comprehensive income categories. As discussed in our response to Question 16, we support retaining the current accounting for financial liabilities, including today's unrestricted fair value option for all financial liabilities. We also support the Boards' proposal to recognize changes in fair value due to changes in a company's own credit risk in other comprehensive income.

***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 agree that reclassifications between measurement categories should be required if there is a change in the company's business model. A subsequent change in business model should be reflected in the accounting to reflect the company's current business model and not the strategy that existed when the instrument was acquired or issued. We further agree that these reclassifications should occur very infrequently.

For practical reasons, we support the recognition of reclassifications on the last day of the reporting period in which the reclassification occurred. However, we recommend the FASB also give companies the option to recognize the reclassification on the date that the business model change occurs. This may be appropriate in certain circumstances, such as when the change results from a business



combination and the date of change is clear.

***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 agree that foreign exchange gains and losses on foreign currency denominated financial assets measured at fair value through other comprehensive income should be recorded in net income.

However, we disagree with the proposed approach to calculate these foreign currency gains and losses based on the fair value of the instrument. As a general principle, the Boards have agreed that financial assets measured at amortized cost and financial assets measured at fair value through other comprehensive income should have the same net income impact, which will be based on amortized cost. The approach proposed by the FASB for calculating foreign exchange gains and losses for debt investments measured at fair value through other comprehensive income would differ from the calculation used for debt investments measured at amortized cost. We believe that foreign exchange gains and losses should be measured based on the amortized cost basis of the investment, which is consistent with the approach for financial assets measured at amortized cost and under IFRS.

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

We generally agree with most of the proposed disclosure requirements as they address the main components of the overall proposal. We question, however, whether the disclosures required for core deposit liabilities would be meaningful for financial statement users. The nature of the disclosures seem to be targeted towards only certain entities, such as depository and lending institutions, but without further clarification it may inadvertently scope in other companies that may accept customer deposits, such as insurance companies. It is not clear to us that this information has relevance outside of traditional depository and lending institutions. Thus, if those disclosures are determined to be helpful, we encourage the FASB to further consider limiting them to only those types of entities.

We do not support the proposal to require presentation of a secondary measurement attribute on the face of the balance sheet, including for financial assets and financial liabilities measured at amortized cost. Presentation on the face of the balance sheet would add unnecessary clutter to the statement, and potentially confuse users as to what measurement attribute should be the primary focus. The notes are an integral part of the financial statements and allow for a better presentation of alternative measurement information. However, if a company determined that presenting such information on the face of the balance sheet would be meaningful to its users, it should have the ability to choose to do so.

***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 understand that many investors are concerned about companies recording gains due to fair value changes triggered by declines in their own credit worthiness. Given this concern, we agree that a company should be able to early adopt the requirement to present changes in fair value due to changes in its own credit risk in other comprehensive income. Additionally, concerns have been raised by users



and preparers under current GAAP regarding the treatment of foreign currency gains and losses on debt investments measured at fair value through other comprehensive income. We believe that companies should be able to early adopt the requirement to recognize in net income the foreign currency gains or losses on debt investments measured at fair value through other comprehensive income. However, as we stated in our response to Question 26, we believe foreign currency gains or losses should be measured based on the amortized cost basis of an instrument. We support prohibiting early adoption of the remainder of the standard on the basis that such early adoption would undermine comparability for financial statement users.

***Question 31: Should the effective date be the same for both public entities and nonpublic entities?***

We generally support giving private companies additional time to implement the guidance and learn from the experiences of public companies. Further, we believe it is important that the effective date for the classification and measurement standard and the credit impairment standard be the same.

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

The amount of time necessary to implement the Proposal will depend on the final standard and on the types and complexity of financial instruments originated by, invested in, and issued by companies. We recommend that ample time be given for companies to address the complexities of the new model and ensure the necessary processes and internal controls are in place. We acknowledge that one of the more time consuming and complex aspects of the Proposal will be the application of the cash flow characteristics assessment to all financial assets. This will be especially complex to apply in transition when analyzing and assessing investments in beneficial interests. As such, we encourage the FASB to seek feedback from preparers on what they believe is the appropriate time needed to implement the Proposal. In addition, since the final standard will impact the accounting for financial instruments that are widely held in the US market, additional time may be needed for market participants to react and make changes to accommodate the new developments.

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

We recognize the challenges of full retrospective application given the significant changes that may be required by the model. In particular, determining whether a financial instrument met the cash flow characteristics and business model tests at historical points in time will likely be challenging. Therefore, we agree with requiring a cumulative-effect adjustment in the balance sheet as of the beginning of the first reporting period in which the guidance is effective.

As previously discussed, we support an unrestricted fair value option for financial assets and financial liabilities. Even if today's fair value option were to be left unchanged, we believe that companies should be given the opportunity to reconsider the fair value option on adoption of the final standard. Some companies may previously have missed their opportunity to apply the fair value option. For example, the scope of the portfolio-wide fair value option was unclear as it related to not-for-profit healthcare entities.

***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 FASB's proposed changes to the equity method of accounting and recommend the current US GAAP guidance, including the fair value option, be retained for these investments. The IASB is not addressing the equity method of accounting in this project and the proposed changes would increase the number of differences in this area. While IFRS also has a held for sale concept, it is a different definition than what the FASB is proposing and the resulting measurement for those investments held for sale is also different (i.e., the lower-of-cost-or market).

We are also concerned that the held-for-sale criteria may be interpreted too broadly and inappropriately scope in certain investments. For example, investments in finite lived entities may be viewed as held-for-sale because they have a definitive liquidation date. If the FASB moves forward with this aspect of the Proposal, we recommend it consider changing the final standard to address these concerns. However, we prefer the FASB retain the current guidance on equity method accounting in the absence of addressing the model holistically.

***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 see the benefit of a more simplified single step impairment approach for equity investments under the practicability exception. As noted above, we prefer that the FASB retain the current guidance on equity method accounting in the absence of addressing the model holistically. While simplifying the impairment model may have certain benefits, we do not believe such changes in isolation of a broad reconsideration of the model are appropriate.

***Question 36: Do you agree that the current portfolio-wide option for not-for-profit entities, other than health care entities, to account for their equity method investments at fair value should be retained? If not, why? Should that option also be made available to not-for-profit health care entities that are within the scope of Topic 954, Health Care Entities?***

We support an unrestricted fair value option that can be elected on an instrument-by-instrument basis by not-for-profit entities. Such a fair value option would alleviate the need for the current portfolio-wide fair value option. A fair value option is important to not-for-profit entities, which often have portfolios of investments that are managed on a fair value basis.

In the absence of an unrestricted fair value option, we support retention of the portfolio-wide fair value option for not-for-profit entities. However, if an unrestricted fair value option is not provided, we encourage the FASB to clarify the scope of that proposed guidance. The description in the proposed consequential amendments is similar to the current guidance and would likely perpetuate existing diversity in practice. For example, today the election is sometimes viewed as "entity-wide" rather than "portfolio-wide." If the FASB's intent is for the option to apply to investments managed as part of a specific portfolio of investments subject to a common strategy, we recommend that should be made clear. In addition, we believe that investments undertaken to accomplish a not-for-profit entity's mission or purpose should be specifically excluded from the portfolio-wide election and be reported under the equity method.

Generally, we believe that not-for-profit *health care* entities should apply the same accounting as their for-profit health care counterparts, unless the underlying economics or the nature of a transaction justifies differences. We therefore believe that not-for-profit healthcare entities should also have an unrestricted instrument-by-instrument fair value option. If an unrestricted fair value option is not



provided, we support a portfolio-wide fair value option consistent with other not-for-profit entities subject to clarification as discussed above.

***Question 37: The proposed amendments would eliminate the fair value option for hybrid nonfinancial instruments in current U.S. GAAP and would provide a new fair value option for hybrid nonfinancial liabilities. For a hybrid nonfinancial liability, an entity would apply the bifurcation and separate accounting requirements in Subtopic 815-15 and account for the embedded derivative in accordance with Topic 815. The financial liability host that results from separation of the nonfinancial embedded derivative would be subject to the proposed amendments. However, an entity would be permitted to initially and subsequently measure the entire hybrid nonfinancial liability at fair value (with changes in fair value recognized in net income) if after applying Subtopic 815-15 the entity determines that an embedded derivative that requires bifurcation and separate accounting exists. In contrast, for a hybrid nonfinancial asset the proposed amendments would require the hybrid contract to be measured at fair value (with changes in fair value recognized in net income) if the hybrid nonfinancial asset contains an embedded derivative that would have required bifurcation and separate accounting under Subtopic 815-15. Do you agree with the proposed amendments? If not, why? What would you propose instead?***

We agree that a hybrid nonfinancial instrument (a financial instrument host contract with a nonfinancial instrument embedded derivative) should follow the same model, subject to our response to Question 4, as other financial instruments on the basis that the economics associated with the instrument are generally similar. That is, the economics behind holding a gold-linked note that is physically settled is very similar to holding an equity-linked note that is cash settled.



**Appendix B - Responses to Questions for Respondents contained in the consequential amendments, issued on April 12, 2013**

***Question 1: Do you believe that the proposed consequential amendments that would result from the proposals in the proposed Update on financial instruments have been appropriately reflected? If not, what alternative amendment(s) do you recommend and why?***

In reviewing the consequential amendments, we noted that the FASB intends to prohibit the application of hedge accounting to hedges of interest rate risk for investments in debt securities classified at amortized cost. However, for loans classified as amortized cost, entities will continue to be permitted to apply hedge accounting for these types of hedges. We do not see a reason to make this distinction, and we support permitting hedge accounting for hedges of interest rate risk for both types of instruments. The new amortized cost category should not be viewed as a continuation of today's held to maturity category and therefore subject to all of its limitations. Notwithstanding an intention to hold an instrument for the collection of contractual cash flows, companies may find it necessary over time to adjust the risk profile of their portfolio through appropriate risk management strategies, and the application of hedge accounting should be permitted regardless of whether the instrument is a loan or a debt security. Additional matters that we noted from our review of the proposed consequential amendments are discussed in our responses to the applicable questions in Appendix A.

***Question 2: Do you believe that all guidance related to financial instruments in various Topics in the FASB Accounting Standards Codification® (for example, Topics 310 and 470) should be consolidated into a single Topic?***

We support consolidating all of the relevant guidance on financial assets that are within the scope of this Proposal into a single topic within the 300 (Assets) section of the codification. This would benefit users of the codification by providing a single point of reference for all technical accounting guidance in this area. While the scope of the proposed credit impairment model differs from the recognition and measurement model in some respects, we also believe it would be beneficial if the credit impairment and interest income recognition models are also contained within that same topic. Similarly, we recommend that all of the guidance related to financial liabilities that are within the scope of this Proposal should be contained in a single topic within the 400 (Liabilities) section of the codification.

***Question 3: The proposed amendments also would eliminate the fair value option (for financial instruments not within the scope of the proposed Update on financial instruments) in current U.S. GAAP (see paragraph 825-10-15-4), related to guarantees, contingencies, rights and obligations of insurance contracts and warranties, written loan commitments, and firm commitments. Do you agree with the proposed elimination and the effective date and transition guidance? If not, why? What would you propose instead?***

We believe the ability to carry any financial instrument at fair value with changes in fair value recognized in net income is important, particularly for financial institutions that manage certain instruments on a fair value basis or for companies that wish to avoid the challenges of applying hedge accounting. Disclosures that enable financial statement users to understand a company's reasons for electing the fair value option continue to be an essential part of the fair value option. For the same reasons, we continue to see the need for an unrestricted fair value option for those instruments that are not within the scope of the Proposal, including guarantees, contingencies, rights and obligations of insurance contracts and warranties, written loan commitments, and firm commitments.