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November 3, 2016

Via email

Mr. Russell Golden, Chairman
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 2016-310: Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815)*, Targeted Improvements to Accounting for Hedging Activities

Dear Mr. Golden:

Wells Fargo & Company (“Wells Fargo”) is a diversified, community-based financial services company with \$1.9 trillion in assets providing banking, insurance, investments, mortgage, and consumer and commercial finance services. We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815)*, Targeted Improvements to Accounting for Hedging Activities (the “Proposal”).

Executive Summary

Wells Fargo supports the primary objectives of the Proposal to improve financial reporting of hedging results to better reflect the economics of an entity’s risk management hedging activities and to implement other targeted improvements to simplify the application of hedge accounting. We use derivatives as a significant component of our overall asset/liability management strategy to manage interest rate and foreign currency risk exposures related to “banking book” assets and liabilities. Accordingly, alignment of our hedge accounting with our risk management strategies and the potential to reduce the costs and effort required to apply hedge accounting are important to us. We applaud the Board’s efforts related to the Proposal and support substantially all of its provisions. However, we have identified the following concerns with the Proposal we would like the Board to consider:

- The Proposal should address the “artificial ineffectiveness” recognized in fair value hedging relationships of foreign-currency-denominated assets or liabilities caused by foreign currency basis spreads;
- Reporting entities should retain the flexibility to report the interest component of the change in fair value of the hedging instrument and hedged item so that net interest margin and other key metrics are not distorted;
- The cost and burden of complying with the disclosure requirements for carrying amounts and cumulative basis adjustments for fair values hedges outweigh the usefulness of this information; and
- Disclosures about quantitative goals are ambiguous and not applicable to financial institutions.

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Specific Comments on the Proposal

A more comprehensive description of our concerns and our recommended improvements to the Proposal are included below.

The Proposal should address the “artificial ineffectiveness” recognized in fair value hedging relationships of foreign-currency-denominated assets or liabilities caused by foreign currency basis spreads.

Companies, including Wells Fargo, commonly issue or purchase foreign-currency-denominated debt instruments in foreign capital markets to diversify funding or investing sources. These debt instruments are often issued or held by entities whose functional currency is different than the denomination of the debt instrument, exposing these entities to foreign currency risk and potentially also interest rate risk. A common approach to hedging foreign currency risk involves the use of foreign currency derivatives, such as cross-currency swaps, cross-currency interest rate swaps or forward foreign currency derivatives. Although a hedge can be designed to virtually eliminate the economic risk exposure to foreign currency risk, a fair value hedge of foreign currency risk will experience artificial ineffectiveness caused by volatility in foreign currency basis spreads (“currency basis spreads”).

Currency basis spreads represent a component of the cross-currency basis discount curve. The cross-currency discount curve is used to present value future foreign currency cash flows to determine the fair value of foreign currency derivatives. The cross-currency basis curve can be decomposed into the foreign currency benchmark interest rate curve plus the applicable currency basis spread. The currency basis spread for each tenor point is derived from spot exchange contracts, forward contracts and cross-currency swaps in the applicable foreign exchange market. Accordingly, the cross-currency basis discount curve considers forward exchange rates between the applicable foreign currency and functional currency.

Volatility in currency basis spreads increased significantly during the financial crisis and the following sovereign debt crisis, and has become a significant and volatile component of the pricing of longer term foreign currency derivatives and foreign-currency-denominated debt instruments. Under current GAAP, volatility in currency basis spreads has long been a source of artificial or uneconomic ineffectiveness for fair value hedges. Market convention incorporates currency basis spreads in fair value measurements of foreign currency derivatives and foreign-currency-denominated debt instruments. However, currency basis spreads may not be considered in the measurement of the change in fair value due to changes in the foreign currency risk component in a fair value hedge.¹ Consequently, the asymmetric treatment of the currency basis spreads in the fair value measurement of the hedged item and the hedging instrument creates ineffectiveness even though the foreign currency risk exposure is perfectly hedged economically.

Consider the following example. An entity with a USD functional currency issues fixed-rate EUR debt and enters into a EUR/USD cross-currency swap. The swap is designated in a fair value hedging relationship to hedge the entity’s exposure to both changes in foreign currency exchange rates and the benchmark interest rate related to the fixed-rate EUR debt. The EUR leg of the swap bears a fixed interest rate and the USD leg bears a floating interest rate indexed to 3 month LIBOR. The measurement of the EUR cash flows of the hedged item (foreign-currency-denominated debt instrument) is discounted using the designated benchmark interest rate (EURIBOR), which considers forward interest rates in the EUR market. The measurement of the EUR cash flows of the hedging instrument (cross-currency swap)

¹ Paragraphs ASC 815-25-35-18 and ASC 815-25-55-109 to 815-25-55-117 state that changes in fair value of foreign-currency-denominated assets or liabilities due to changes in the foreign currency risk component is measured using spot exchange rates.

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is discounted using the cross-currency basis discount curve², which considers both forward interest rates (EURIBOR) and forward foreign currency exchange rates. Because valuation changes due to changes in EUR/USD cross-currency basis spreads are reflected in the hedging instrument but not the hedged item, the entity must recognize ineffectiveness related to the change in fair value of the hedging instrument due to changes in EUR/USD cross-currency basis spreads.

In contrast, this source of ineffectiveness is not present in a cash flow hedge of the same risk whereby changes in the hedged risk are measured using the hypothetical derivative method. This is because the fair value measurements of both the hedged item and hedging instrument incorporate the currency basis spread. Consistent with the Board's objective to conform the accounting for the hedged item in fair value hedges where current GAAP results in treatment inconsistent with the economics and the cash flow hedging model (e.g., hedging the benchmark component of the contractual cash flows and partial-term hedging), we believe the Board should address this issue involving fair value hedges of foreign currency risk.

We recommend the following enhancements, in order of preference, to better align the economic substance and risk management with hedge accounting:

1. Expand the use of the hypothetical derivative method to fair value hedges of foreign currency risk. The hypothetical derivative method will eliminate the uneconomic ineffectiveness experienced in today's model as the fair value measurements of both the hedged item and hedging instrument incorporate the currency basis spread.
2. Permit the use of the cross-currency basis discount curve to discount the foreign-currency-denominated cash flows of the hedged item in a fair value hedging relationship involving foreign currency risk. This approach would more closely align with how market participants measure the foreign currency risk component when determining the fair value of foreign-currency-denominated financial instruments.
3. Permit recognition of the change in fair value of the hedging instrument attributable to changes in currency basis spreads related to the derivative in accumulated other comprehensive income with systematic recognition in earnings.³

We have provided detailed examples of this issue and solution number 2 above to the FASB staff in a separate presentation dated October 28, 2016.

Reporting entities should retain the flexibility to report the interest component of the change in fair value of the hedging instrument and hedged item so that net interest margin and other key metrics are not distorted.

Under the Proposal, the entire change in the fair value (including the interest component) of the hedging instrument and hedged item designated in a fair value hedge must be presented in a single income statement line item for each risk being hedged. For fair value hedges of interest rate risk, this change will

² The EUR/USD cross-currency basis discount curve is the sum of the EURIBOR interest rate curve plus the applicable EUR/USD currency basis spread.

³ This option would be consistent with the IASB hedge accounting framework in International Financial Reporting Standard 9 – *Financial Instruments* (“IFRS 9”). The IASB provided this option to address respondent's concerns related to changes in forward foreign currency exchange rates in fair value hedges of foreign currency risk. The effect of this solution addressed the uneconomic ineffectiveness caused by changes in currency basis spreads.

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be recognized in net interest income. The presentation of fair value changes within net interest income will distort net interest income and yield, which are key metrics used by investors to evaluate the performance of a financial institution. Given the asset/liability management objective of these hedging activities is typically to convert fixed-rate interest cash flows to a floating-rate, the effects of which are manifested in net interest income, many financial institutions, including Wells Fargo, reflect the contractual interest paid or received related to the hedging instrument and hedged item within net interest income. The remaining change in fair value of the hedging instrument and hedged item are recognized outside of net interest income. This practice has been in existence for many years and the effects of the hedging instrument and hedged item on the individual income statement line items is disclosed. For this reason and because fair value hedge accounting adjustments (other than the contractual interest paid or received) are similar in nature to fair value adjustments to financial assets or liabilities measured at fair value or lower or cost or fair value, we believe it is more appropriate to continue to present these adjustments outside of net interest income.

We recommend the Board permit companies the flexibility to present income statement impacts of its fair value hedging activities in a manner that aligns financial reporting of hedging results with its risk management activities while at the same time requiring transparent disclosure of the hedging effects in the financial statement footnotes.

The cost and burden of complying with the disclosure requirements for carrying amounts and cumulative basis adjustments for fair values hedges outweigh the usefulness of this information.

The Proposal requires disclosure of the cumulative basis adjustments for fair value hedge recognized on the balance sheet as of the reporting date, including disclosure of the component (if any) related to hedging relationships that have been previously discontinued. We acknowledge the Board's desire to provide users this information to better understand the effect of fair value hedge accounting on the balance sheet. However, contrary to the Board's understanding that this information is readily available⁴, our current operational infrastructure does not support providing this information on both a historical and ongoing basis without significant system and process enhancements. The specific reasons are as follows:

- We do not separately track the remaining balance of fair value hedge basis adjustments recorded to the hedged item related to hedging relationships that have been previously discontinued. In accordance with current GAAP, upon termination of the fair value hedging relationship, these fair value hedge basis adjustments are combined with the existing basis adjustments unrelated to hedge accounting (e.g., purchase premiums or discounts, deferred fees or costs, etc.) into a single premium or discount which is amortized or accreted into earnings using the effective interest method. In such instances, we are currently unable to isolate the component of the remaining basis adjustment related to fair value hedge accounting.
- We do not separately track fair value hedge accounting basis adjustments related to measuring foreign currency risk of foreign-currency-denominated asset or liabilities. Such assets or liabilities require re-measurement into the reporting entity's functional currency at prevailing spot exchange rates regardless of whether the asset or liability is designated in a fair value hedging relationship. Accordingly, to comply with the disclosure requirement, reporting entities would be required to track and isolate the component of the cumulative basis adjustment related to measurement of foreign currency risk specific to the time period(s) during which the foreign-currency-denominated asset or liability was designated in a fair value hedging relationship. This time period may not be

⁴ See paragraph BC153 of the Proposal.

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the entire time period the reporting entity recognized the asset or liability on its balance sheet. Additionally, we question how users will find this information useful.

We recommend the Board reconsider whether these incremental disclosure requirements provide decision useful information that is justifiable in light of the significant operational burden imposed on preparers to comply, which includes obtaining historical information not readily available and implementation of significant system and process enhancements. We believe existing and the other disclosures in the Proposal provide users sufficient information to understand the financial impacts of hedge accounting activities.

Disclosures about quantitative goals are ambiguous and not applicable to financial institutions.

The proposed disclosure of the quantitative goals related to outstanding hedging relationships is ambiguous and does not consider the complexity of a diversified financial services company's risk management strategies. Asset/liability management generally involves evaluating, monitoring and managing many risks, including risks related to interest rates, liquidity, market risk and foreign currencies. Using interest rate risk as an example, we assess various outcomes based on earnings simulations of multiple interest rate scenarios that consider the direction of interest rate changes, degree of change over time, speed of change and projected shape of the yield curve. These simulations require assumptions regarding how changes in interest rates and related market conditions could influence earnings drivers and balance sheet composition, such as loan origination demand, prepayment speeds, deposit balances and mix, as well as pricing strategies. Accordingly, management considers multiple factors in the determination of its hedge accounting objectives and does not have quantitative goals that can be isolated to its hedge accounting activities. Given these concerns and the ambiguous nature of the Proposal, we do not believe the proposed disclosures are practicable or would be comparable among reporting entities. Existing disclosures, read in conjunction with Management's Discussion & Analysis, should already provide users with sufficient decision useful information.

Conclusion

We encourage the FASB to consider our recommendations described in this letter and in particular, urge the FASB to consider our concerns related to the fair value hedge accounting involving foreign-currency-denominated assets or liabilities. We believe that our recommendations will accomplish the project goals of simplification and reduced complexity as well as improve the transparency and understanding of information for financial statement users.

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We appreciate the opportunity to comment on the issues contained in the Board's invitation. If you have any questions, please contact me at 704-383-6557 or Mario Mastrantoni at 704-383-9678.

Sincerely,

/s/ Richard D. Levy

Richard D. Levy
Executive Vice President & Controllor