Proposed FASB Standard on Financial Instruments

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Discussion Topics

Proposed FASB Standard on Financial Instruments

- Classification and Measurement
- Credit Impairment
- Netting/Offsetting
- Proposed Hedge Accounting Requirements

Classification and Measurement

Classification and Measurement

- Based on the characteristics of the instrument and the bank's business strategy
  - Financial assets will fall into one of three categories based on business activity
  - Financial liabilities will be carried at amortized cost unless the bank has the ability and means to transact at fair value

Classification and Measurement

- Fair value for all financial instruments except demand deposit liabilities presented parenthetically on the face of the balance sheet
- No reclassifications permitted and no tainting
- No fair value option except for certain hybrid instruments

Financial Asset Classification

Categories	Current	Proposed
Amortized Cost	HTM – Positive intent and ability to hold to maturity	Instruments not held for sale and managed as loans with sales limited to efforts to minimize losses due to deteriorating credit
Fair Value thru OCI	AFS – All securities not HTM or Trading	Instruments not held for sale and invested either to maximize total return or to manage interest rate or liquidity risk
Fair Value thru Net Income	Trading – Securities held for the purpose of selling in the near term	Instruments held for sale and those not meeting the FV-OCI requirements

Amortized Cost Category

- Business Strategy Criterion
  - Must meet all of the following
    - Manage through customer financing or lending activities with a primary focus on collection of substantially all contractual cash flows
    - Holder has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss
    - Sales or settlements limited to circumstances that would minimize losses due to deteriorating credit
    - Not held for sale

Amortized Cost Category

- Plain vanilla loans probably qualify but exotic loans and loans originated for sale may not
- Debt securities would not meet the criteria so they will be at fair value through OCI or Net Income

Classification and Measurement

Interaction with Basel III

Common Equity Tier 1

- Basel III introduces a Common Equity Tier 1 capital requirement
- Common Equity Tier 1 =
  - common equity (common shares, stock surplus, retained earnings, additional paid in capital)
  - plus limited minority interest meeting Common Equity Tier 1 criteria
  - minus deductions
- Gains and losses on Available-for-Sale securities are not neutralized

Liquidity Coverage Ratio (LCR)

$$\frac{\text{Stock of High Quality Unencumbered Liquid Assets}}{\text{Net Cash Outflows Over 30 Days Under a Specified Scenario}} \geq 100\%$$

- **Promotes short-term resiliency by ensuring that banks have sufficient high quality liquid resources to survive an acute stress scenario lasting for one month**
- **Encourages holdings of highly liquid securities such as US Treasuries and Agencies**
  - More work is still required over an observation period
  - Monitoring to start in 2011
  - Minimum standard to start in 2015

Accounting Interaction

- Basel III liquidity provisions encourage the holding of highly liquid securities such as US Treasuries and Agencies
- Current FASB work on the classification and measurement of financial instruments may not permit US Treasuries and Agencies in an amortized cost category like the current HTM
  - Most likely, such securities would be classified in a category like the current AFS
- Basel III requires gains and losses on AFS securities to flow through regulatory capital
- Regulatory capital could become much more volatile
  - Issue impacts many more types of securities currently classified as HTM or AFS including municipal securities commonly held by community banks

Credit Impairment

Allowance for Loan Losses

- US GAAP is currently based on an incurred credit loss model, whereby:
  - A loan is impaired when it is **probable** that a loss has been incurred based on past events and conditions existing at the balance sheet date
    - Does not consider possible or expected future trends that may lead to additional losses

Allowance for Loan Losses

- In light of the recent financial crisis, FASB and IASB have been working jointly on revised standards
  - Would move US GAAP from an incurred loss model to a more forward-looking expected loss model for estimating credit losses
  - An institution would determine the ALLL by aggregating expected credit losses from its "good book" its "bad book" and its "ugly book" of loans
- FASB expects to issue a final standard in 2011

Allowance for Loan Losses

Good Book

- **No observable events that provide direct evidence of a possible future default**
  - Would require segmentation based on loan characteristics, performance, and possibly macroeconomic indicators
- Reserve for 12 or 24 months of expected losses using an annual loss rate methodology

Bad Book

- **Observable events indicate possible future defaults but specific assets in danger of default are not yet identifiable**
  - Contemplates a segment, pool, or vintage as opposed to individual loans
- Reserve for the full lifetime expected losses using a statistical method applied to segments within this book

Ugly Book

- **Observable events specifically identify individual loans for which credit losses are expected to, or have, occurred**
- Reserve for the full lifetime expected losses by computing the loss directly for each loan within this book
  - In concept, this is very similar to the current FAS 114 approach but it will require use of forward-looking information

Remaining Issues for Discussion

- Relative vs. Absolute
  - Should loans purchased at a discount be bucketed in the Good Book by default or in another book based on credit risk relative to contractual terms?
- Debt Securities
  - Securities accounted for at amortized cost or fair value through OCI will require an allowance
  - Does the proposed model work well for securities?

Possible Implications

- The proposal:
  - Would likely result in earlier recognition of loan losses
  - May result in higher ALLL levels, based on management's estimate of expected future credit losses
  - Would require institutions to revise existing methodologies based on the incurred loss model
  - Definitely requires more use of judgment

Netting/Offsetting

FASB Project Objectives

- Differences in current offsetting (netting) requirements account for the single largest quantitative difference in amounts presented in statement of financial position prepared in accordance with U.S. GAAP and those prepared in accordance with IFRS
- Joint FASB and IASB proposals would have converged accounting in this area
- The boards felt this proposal would provide information that is useful for assessing the following:
  - Entity's ability to generate cash in the future (the prospects for future net cash flows)
  - The nature and amounts of the entity's economic resources and claims against the entity, and
  - The entity's liquidity and solvency
- Final standard expected around the end of 2011

Proposed Offsetting Criteria

- Entity is required to net eligible assets and liabilities when:
  1. It has an unconditional and legally enforceable right of setoff; and
  2. It intends either:
     a. To settle the eligible asset and eligible liability on a net basis, or
     b. To realize the eligible asset and settle the eligible liability simultaneously
        - Simultaneously defined as "at the same moment"

Impact Analysis

Comparison of Net and Gross Derivative Positions
Public Company Data from September 30, 2010
Data in $ millions

	JPMorgan Chase		Bank of America		Citigroup		Goldman Sachs		Wells Fargo		BNY Mellon		Total Asset
	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Netting
Gross Derivative	1,990,685	1,945,591	2,093,300	2,059,000	894,655	904,251	991,464	871,547	110,690	103,160	29,785	29,511	
Netting Adjustment	1,893,392	1,870,689	2,008,600	1,997,300	825,131	830,498	909,990	807,780	87,944	95,368	22,038	21,538	**5,747,095**
Net Derivatives	97,293	74,902	84,700	61,700	69,524	73,753	81,474	63,767	22,746	7,792	7,747	7,973	
Total Assets	2,141,595		2,339,660		1,983,280		908,679		1,220,784		254,157		

	Deutsche Bank		UBS		HSBC	
	Asset	Liability	Asset	Liability	Asset	Liability
Gross Derivative	1,115,953	1,089,694	529,667	512,250	418,760	417,495
Netting Adjustment *	1,034,512	N/A	452,829	433,364	130,481	130,481
Net Derivatives	81,441		76,838	78,887	288,279	287,014

* DB and UBS netting adjustment is for disclosure of leverage ratio purposes only. HSBC netting is recognized on its balance sheet under IFRS.

- This proposal, as written, would have eliminated virtually all netting currently permitted under U.S. GAAP and under IFRS

Next Steps

- FASB and IASB could not agree on net vs. gross balance sheet presentation
- Current US netting of derivatives and repurchase agreements will continue
- FASB and IASB will require disclosures such that financial statement users can easily adjust for divergent presentation

Proposed Hedge Accounting Requirements

Moving Forward on Hedging

- FASB proposed modest modifications to current hedge accounting standards
  - Comments were generally positive
- IASB proposed a significant overhaul of hedge accounting
  - Comments were also generally positive
- FASB exposed IASB proposal for consideration in the U.S.
  - Comments from the industry were positive and from others were mixed
- Who knows where are we going but there is a concern about lack of convergence on this topic

FASB Hedge Accounting Proposal

- Remove provisions that led to many restatements – shortcut and critical terms match methods for assessing effectiveness
- Remove bright lines that developed to define "highly effective"
  - Introduce "reasonably effective" as the appropriate criteria and indicate that it can be assessed from a qualitative standpoint in many cases
  - After inception, evaluate only if circumstances change
- Eliminate opportunity to "de-designate" a hedge
  - Hedge accounting can be discontinued only if accounting criteria are no longer met or if the hedging instrument expires, is sold, terminated, or exercised

IASB Hedge Accounting Proposal

- Objective to mirror an institution's risk management activities for exposures that could affect profit or loss
- Responsive to complaints that current requirements are too prescriptive and do not align with risk management practices
- Includes comprehensive disclosure:
  - Risks the institution is managing and how it is managing those risks
  - Outcomes of risk management activity, including the effect on the institution's financial statements

IASB Hedge Accounting Proposal

- Would replace strict quantitative threshold for hedge accounting (80% to 125% offset) with a more qualitative approach
- Proposed hedging criteria:
  - Hedge relationship produces an unbiased result
  - Hedge relationship minimizes expected hedge ineffectiveness
  - Hedge offset is "other than accidental"
- Broadly supported by the industry
- Supervisors concerned about unintended consequences → may lead to unsound hedging practices