

FASB Proposal on Mark-to-Market and Financial Instruments

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Presented By:

Thomas A. Humphreys, Morrison & Foerster LLP

Anna T. Pinedo, Morrison & Foerster LLP

Thomas Rees, FTI Consulting

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 - FASB/IASB joint efforts/convergence
- Overview of Proposal
- Recognition and Measurement Provisions
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- Tax & Accounting Differences
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Panel

- Anna T. Pinedo, Corporate Partner, Morrison & Foerster LLP
- Thomas Rees, Managing Director, FTI Consulting
- Thomas A. Humphreys, Tax Partner, Morrison & Foerster LLP

Standard Disclaimer

The views that I express in this presentation are my own and are not necessarily representative of the views of FTI Consulting

Background

FASB Action

- May 26, 2010, the FASB released its proposed changes, “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities”
- Comments on this proposal are due September 30, 2010
- Many commenters have focused on the mark to market aspects of the proposal and the anticipated effects on banks. These are, of course, significant. But, the proposal is quite comprehensive and also affects:
 - Impairment, and
 - Hedge accounting
 - Presentation and disclosure requirements

FASB/IASB Collaboration

- Regulators have identified the importance of harmonizing accounting standards
 - The G20 has emphasized that convergence of accounting standards will be useful for both regulators and investors
 - The SEC has been working for some time now on its GAAP/IFRS convergence project
- Thus far, the IASB approach and the FASB approach differ
- The IASB standard would require more balance sheet items to be carried at amortized cost and changes to be kept out of net income

Comparison with IASB Approach

FASB's Financial Instruments Proposal

Comparison with IASB:

- FASB issued an exposure draft in May 2010 that comprehensively addresses financial instruments
- IASB will issue multiple exposure drafts to address financial instrument accounting
 - Classification and measurement:
 - Issued IFRS 9 in November 2009;
 - Issued ED on fair value option for liabilities in May 2010
 - Impairment: issued November 2009, comment period ended 6/30/2010
 - Hedge Accounting: ED to be issued in 2010

FASB's Financial Instruments Proposal

Comparison with IASB:

- Although called a “joint project,” FASB and IASB are headed in different directions
- Potentially different treatment for loans, debt securities, equity securities, deposits, liabilities and hybrid instruments; impairment assessment would also be different
- FASB places greater emphasis on fair value accounting, IASB retains amortized cost accounting for more financial instruments

Overview

FASB's Financial Instruments Proposal

Project Objectives:

- Establish comprehensive principles to classify and measure all financial instruments; eliminate different treatment for economically similar instruments
- Provide more timely and representative presentation of financial instruments
- Reduce complexity
 - Establish a single model for estimating credit losses
 - Simplify hedge accounting

FASB's Financial Instruments Proposal

Scope:

- All financial assets and liabilities that are not specifically excluded from scope
- Exclusions include:
 - Employee benefit plans
 - Insurance Contracts
 - Lease Contracts
 - Equity investments in consolidated subsidiaries
 - Variable Interest Entities

Recognition and Measurement Provisions

Recognition and Measurement Provisions

Three Principal Categories:

- Fair value, with changes in fair value recognized in net income (FV-NI); (default)
- Fair value, with certain changes in fair value recognized in other comprehensive income (FV-OCI)
- Amortized cost

Recognition and Measurement Provisions

FV with changes recognized in Net Income:

- Initial measurement at fair value
- Any difference between the transaction price and FV is immediately recognized as a gain or loss in net income.
- Must identify whether the transaction includes “other elements”
- Transaction fees and costs recognized in net income immediately as incurred.
- All equity securities now at fair value

Recognition and Measurement Provisions

Examples FV-NI:

- Trading instruments
- Derivatives
- Equity securities
- Hybrid instruments
- Interest-only strips

Recognition and Measurement Provisions

Presentation FV-NI:

- Only the fair value amount is required to be presented on the balance sheet
- Amortized cost must also be presented for outstanding debt

Recognition and Measurement Provisions

FV with certain changes recognized in OCI:

- A financial asset or liability that is a debt instrument may be classified as FV-OCI if three criteria are met:
 - Cash flow characteristics
 - Business Strategy
 - Embedded derivatives are not required to be separated
- FV-OCI instruments subject to a credit impairment model
- Amounts recorded in OCI would be recorded in net income when instrument is sold or settled

Recognition and Measurement Provisions

FV with certain changes recognized in OCI:

- Cash flow characteristics:
 - A debt instrument with a principal amount that is transferred to the issuer at inception and which will be returned to the investor at maturity
 - The contract terms identify additional contractual cash flows to be paid to the investor either periodically (i.e., interest) or at the end of the instrument's term
 - The debt instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initially recorded investment, other than through its own choice

Recognition and Measurement Provisions

FV with certain changes recognized in OCI:

- Business Strategy:
 - The entity's business strategy for the instrument is to collect or pay the related contractual cash flows rather than to sell the financial asset or to settle the financial liability with a third party
 - Assessment is made on a portfolio basis, not instrument by instrument

Recognition and Measurement Provisions

Examples FV-OCI:

- Loans
- Debt Securities
- Certain Beneficial interests

Recognition and Measurement Provisions

Presentation FV-OCI:

- Assets would be presented as follows:

Cost/Amortized Cost	XXX	
Allowance for Credit Loss		(XX)
<u>Residual FV Adjustment</u>	<u>(XX)</u>	
Fair Value		XXX

Recognition and Measurement Provisions

Presentation FV-OCI:

- Liabilities would be presented as follows:

Cost/Amortized Cost	XXX	
<u>FV Adjustment</u>	<u>(XX)</u>	
Fair Value		XXX

Recognition and Measurement Provisions

Amortized Cost:

- An entity may measure at amortized cost short term receivables and payables, if:
 - Arise in the normal course of business
 - Due in customary terms not exceeding one year
 - Meet the criteria for the FV-OCI classification
- Financial assets other than short-term receivables cannot be classified as amortized cost

Recognition and Measurement Provisions

Amortized Cost:

- An entity may elect to classify financial liabilities (other than deposit liabilities) as amortized cost if both of the following criteria were met:
 - The liability meets the criteria for FV-OCI classification
 - Measurement of the financial liability at fair value would create or exacerbate an accounting mismatch of recognized assets and liabilities:
 - Contractually linked to amortized cost asset
 - Liability in operating segment with less than 50% assets measured at fair value

Recognition and Measurement Provisions

Examples Amortized Cost:

- Short-term Accounts Receivable
- Entity's own debt

Effect on banks of mark to market

- Arguably more procyclical
 - During the financial crisis we dealt with fair value accounting for securities
 - During another period of stress, will new mark to market require banks to take significant losses
- How will it affect banks with significant commercial real estate related loans?
- Will it reduce the availability of credit?
 - We are seeing an interplay of changes that are affecting banks, from Dodd-Frank to Basel, which together impose more stringent regulatory capital requirements and reduce permitted leverage
 - We would have to overlay this as well

Hedge Accounting Provisions

Hedge Accounting Provisions

- Existing accounting requirements for derivatives and hedge accounting have been considered overly complex and have resulted in many restatements
- FASB proposed significant changes to hedge accounting rules (FAS 133) in June 2008, with an intent to simplify requirements
- Current proposal is generally consistent with FASB's 2008 proposal to modify derivative/hedge accounting rules
- No change to types of items, transactions and risks eligible for hedge accounting

Hedge Accounting Provisions

- Changes apply to all existing hedging relationships
- Lowers threshold to qualify for hedge accounting from “highly effective” to “reasonably effective” (judgment is required)
- Eliminates the requirement to assess hedge effectiveness quantitatively
 - A qualitative assessment demonstrating an economic relationship exists between hedged item and hedging instrument may be sufficient
- Eliminates the “short-cut” and “critical terms match” methods of hedge accounting
 - Cannot assume that hedge is perfectly effective

Hedge Accounting Provisions

- Ineffectiveness measured by the change in FV of the actual hedging instrument with the present value of the cumulative change in expected future cash flows of the hedged transaction
- Ineffectiveness for “underhedges” would now be recognized in earnings
- Bifurcation by risk type is still permitted (a change from June 08 exposure draft)

Hedge Accounting Provisions

Termination of Hedging

- Entities would be prohibited from electing to remove a hedge designation
- Hedge relationships may be discontinued only if it no longer meets the required hedging criteria or if the hedging instrument expires, is sold is terminated or exercised.
- An entity can terminate a hedge if it enters into an offsetting derivative.

Impairment Provisions

Impairment Provisions

- A single credit impairment model for all financial instruments in the FV-OCI category and short-term receivables measured at amortized cost
- Impairment on securities and loans would now be measured in a consistent way
- Impairment recognized when an entity does not expect to collect “all contractual amounts due” for originated assets or all amounts originally expected upon acquisition for purchased assets
- Impairment recognized for either a shortfall or a delay in the cash flows

Impairment Provisions

- The estimate of cash flows not expected to be collected would be based on all available information relating to past events, current conditions, and their implications that are relevant to the collectability of the financial asset
- For collateral dependent assets, use of FV of collateral is permitted
- No consideration of forecasts of possible future events and conditions
- No probability threshold

Impairment Provisions

- Measured on an asset-by-asset basis or a pool basis
 - For individual assets, use PV of expected recoverable cash flows or FV of collateral
 - For portfolio basis assessment, apply historical loss rate (adjusted for current conditions) to a pool of assets with similar credit risk

Impairment Provisions

- No OTTI (“other than temporary impairment”) determination required
- Recoveries (reversals) are permitted
- Recognize credit loss in net income with offset to allowance
- Changes in expected cash flows will result in gains or losses through net income in future periods

Other Provisions

Other Provisions

Valuation of Deposit Liabilities

- Historically, banks have opposed fair value accounting because of inconsistent treatment between assets and liabilities (core deposits)
- Under proposal, deposits without a contractual maturity that management considers to be a stable source of funds would be measured at the present value of the average core deposit amount over the implied maturity of the deposits
- Determined separately for each major type of deposit
- Deposit liabilities that are not core deposit liabilities are measured at fair value

Other Provisions

Valuation of Deposit Liabilities

- Discount rate for the core deposit amount equals the difference between the alternative funds rate (the rate of the next available source of funds) and the all-in-cost-to-service rate (includes the all-in costs of maintaining the branch network)
- Changes in remeasurement amount recorded through net income or through other comprehensive income in specified circumstances
- Disclosure of all inputs would be required

Other Provisions

Accrual of Interest Income

- Entities recognize interest income by applying the effective interest rate (EIR) of the financial asset to its amortized cost basis (rather than fair value carrying amount), net of the allowance for impairment
- For originated financial assets, the EIR is the rate that equates the contractual cash flows (adjusted for any initial net deferred loan fees or costs, premium or discount) with the initial cash outflow (i.e., contractual rate adjusted for any deferred loan fees, costs, premiums or discounts)
- For purchased financial assets, EIR is the rate that equates the transaction price to the expected cash flows at acquisition

Other Provisions

Equity Method Investments

- Equity Method accounting only if:
 - Investor has significant influence over investee, and
 - Investee's operations are related to investor's consolidated operations
- If equity method accounting, use cost (no fair value through net income option)

Tax Comparison

Dealers in Securities—Section 475

- Section 475(a)(2)--In the case of any security which is not inventory in the hands of the dealer and which is held at the close of any taxable year—
- (A) the dealer shall recognize gain or loss as if such security were sold for its fair market value on the last business day of such taxable year, and
- (B) any gain or loss shall be taken into account for such taxable year.

Dealers in Securities—Section 475

- **Section 475(c)(2) Security defined.**

The term “security” means any—

- (A) share of stock in a corporation;
- (B) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust;
- (C) note, bond, debenture, or other evidence of indebtedness;
- (D) interest rate, currency, or equity notional principal contract;
- (E) evidence of an interest in, or a derivative financial instrument in, any security described in subparagraph (A), (B), (C), or (D), or any currency...; and
- (F) position which—
 - (i) is not a security described in subparagraph (A), (B), (C), (D), or (E),
 - (ii) is a hedge with respect to such a security, and
 - (iii) is clearly identified in the dealer's records as being described in this subparagraph before the close of the day on which it was acquired or entered into (or such other time as the Secretary may by regulations prescribe).

Dealers in Securities—Section 475

- **Section 475(d)(3) Character of gain or loss.**
- (A) In general. Except as provided in subparagraph (B) or section 1236(b) —
- (i) In general. Any gain or loss with respect to a security under subsection (a)(2) shall be treated as ordinary income or loss.

Dealers in Securities—Section 475

- A dealer in securities marks to market derivatives that it issues, e.g., a financial institution that issues structured notes to investors
- However, a dealer in securities cannot mark to market a debt instrument that it issues
- Accordingly, different tax treatment for structured notes treated as debt for federal income tax purposes (basically principal protected notes) and structured notes not treated as debt for federal income tax purposes

Regs. Section 1.1275-6

- Permits integration treatment for
 - Qualified Debt Instrument Hedge
- Drafted originally to follow accounting treatment
- Example #1
 - Issuer issues a \$1000x three year structured note that pays principal plus the percentage increase, if any, in the S&P Index during the note's term
 - Issuer hedges the structured note by entering into a notional principal contract (i.e., a "swap") where Issuer pays LIBOR plus 100 basis points on a \$1000x notional principal amount and Issuer receives the S&P 500 Index payment at maturity
 - The integrated transaction is a \$1000x three year borrowing at LIBOR plus 100; this only affects Issuer's tax treatment, not the note holders

Regs. Section 1.1275-6

- Example #2:
 - Issuer issues a convertible bond with a \$1000x face amount and issue price; the bond is convertible into 10 shares of Issuer common stock worth \$80x per share on the issue date
 - Issuer buys a call option on 10 shares of its stock from broker at a \$10 strike per share, paying \$15x per share for the call; term of the call matches term of the convertible bond
 - Issuer integrates the convertible bond and call, the integrated debt instrument is treated as a \$1000x bond issued for \$850x, thereby creating \$150x of original issue discount which Issuer deducts over bond's term.

Non-Dealers

- Regs. Section 1.1221-2(a)(1) excludes from capital asset treatment property that is part of a Hedging Transaction:
- **Hedging transaction defined.** Section 1221(b)(2)(A) provides that a hedging transaction is any transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—
- (1) To manage risk of price changes or currency fluctuations with respect to ordinary property (as defined in paragraph (c)(2) of this section) that is held or to be held by the taxpayer;
- (2) To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.



Timeline

Timeline for Implementation

- Comments on proposal are due by September 30, 2010
- Exposure draft does not include a proposed effective date; effective date will be established during redeliberations
- Adoption is not expected before January 2013
- 4-year deferral for nonpublic entities with < \$1 billion in total consolidated assets
- International convergence will have an impact

FTI: The Company Behind the Headlines

- Founded in 1982
- NYSE listed company (Symbol: FCN)
- Over \$1.4 billion in annual revenue
- More than 3,500 employees worldwide
- Offices in more than 50 cities throughout the world and in every major business center

Thomas Rees



Thomas G. Rees is a Managing Director in FTI's Forensic and Litigation Consulting practice located in King of Prussia, PA. He provides clients with a variety of consulting and litigation related services, including determining the accounting for complex transactions, conducting forensic accounting examinations and preparing expert testimony. Mr. Rees has extensive experience researching and interpreting generally accepted accounting principles (GAAP) and specific expertise in capital markets and financial instruments including derivatives and securitization. He specializes in banking and SEC matters, including fair value accounting, valuing complex securities, preparation of SEC filings, and accounting position papers, responding to SEC comment letters and helping to resolve the accounting and disclosure issues in SEC enforcement actions.

Mr. Rees previously served as the Deputy Chief Accountant at the Office of the Comptroller of the Currency (OCC), a Division of the U.S. Treasury Department responsible for regulating national banks. In his ten years with the OCC, Mr. Rees held management positions in the Chief Accountant's Office and the Treasury and Market Risk Division and was responsible for developing and interpreting supervisory policy relating to accounting, auditing, financial reporting, capital markets, risk-based capital and risk management.

Tom is a frequent speaker at industry conferences on emerging accounting issues. Currently, he leads accounting seminars for the Center for Professional Education, Inc. and is an adjunct faculty member of the University of Maryland, University College. Mr. Rees holds an M.B.A. from the University of Delaware and a B.S. in Accounting from Arizona State University. He is a Certified Public Accountant, a Certified Fraud Examiner and a Chartered Financial Analyst and is a member of the CFA Institute and the American Institute of Certified Public Accountants.

King of Prussia PA, • 610 757-1259 • thomas.rees@fticonsulting.com