



September 26, 2007

Mr. Russell G. Golden  
Director of Technical Application & Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7 PO Box 5116  
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LETTER OF COMMENT NO. 31

**File Reference: Proposed Issue E23-Hedging-General: Issues Involving the Application of the Shortcut Method under Paragraph 68**

Dear Mr. Golden:

ACLI is the principal trade association of life insurance companies, representing 373 member companies that account for 91 percent of total assets, 90 percent of the life insurance premiums and 95 percent of annuity considerations in the United States. GNAIE consists of Chief Financial Officers of leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations.

Our organizations would like to offer the following comments regarding the exposure draft. While we agree with most of the proposed guidance, we are especially concerned with the conclusions reached with respect to the short-cut method and the Board's rationale for drawing their conclusions. Our experience has shown that not all hedges that currently qualify for short-cut will be effective using quantitative testing, because of the requirement to include all contractual cash flows for benchmark interest rate hedges. Additionally, it is unclear as to whether the proposed late hedging guidance in paragraph 68(e) is applicable to cash flow hedges.

**Issue 1:**

The proposed guidance would add the following language to Statement 133, paragraph 68(e):

“Any other terms in the interest-bearing financial instruments or interest rate swaps are both typical of those instruments and do not invalidate the assumption of no ineffectiveness. That is, the terms of the interest rate swap and the interest-bearing financial instrument must both:

1. Be typical for those instruments; and
2. Not invalidate the assumption of no ineffectiveness.

For example, in a fair value hedging relationship the fair value of the hedged item must equal its par value at inception of the hedging relationship because the amortization of the initial difference (a discount or premium) would create ineffectiveness. However, an exception to this principle exists, as follows: A difference between fair value and par value of the hedged item would not invalidate the assumption of no ineffectiveness if the difference is a discount or premium attributable solely to the market convention of rounding the coupon rate of the hedged item at issuance.”

In the “ALTERNATIVE VIEWS” section of the proposal the following statement is made:

“Those Board members would not amend Statement 133 to impose this new requirement. They believe that changes in the fair value of a debt instrument prior to the hedge transaction do not distort the effectiveness of the hedging relationship going forward, provided that the terms of the swap match the remaining terms of the debt. **In that case, it is still reasonable to assume that changes in the fair value of the swap will be highly effective in offsetting subsequent changes in the fair value of the debt attributable solely to subsequent changes in the benchmark interest rate (emphasis added).**”

Our assessment of this proposal is that the guidance would preclude short-cut accounting for certain fair value hedges of assets purchased in the secondary market or not hedged at issuance. The Board’s assumption that changes in the fair value of the swap will be highly effective is not always true. For example, current regulations require all contractual cash flow be included in the hedge effectiveness test for fair value hedges of benchmark interest rate risk. An excerpt from FASB Statement 133 paragraph 21F notes:

In calculating the change in the hedged item's fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item's contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.

As a result, hedges of assets with larger credit spreads will not always meet the highly effective criteria, even though it would pass the short-cut method under pre-E23 guidance. If filers could remove contractual cash flows not tied directly to the hedged risk (for example, the portion of the interest coupon in excess of the benchmark interest rate), the Board’s assumption in the “ALTERNATIVE VIEW” would be correct. This elimination of contractual cash flow not tied to hedge risk is allowed under IFRS, which is a more principle based standard. The attached example is offered that illustrates our concern.

The IASB has recently released an exposure draft for comment that amends IAS 39 to explicitly allow for portions of cash flows of financial instruments to be designated in hedges. It was the board’s feeling that this was already common practice and would not change current practice.

## **Issue 2:**

Currently, it is unclear whether the proposed late hedging guidance is applicable to cash flow hedges. Within the Basis for Conclusions section of the proposal, the Hedge Relationship Begins After Hedged Item is Recognized subsection specifically describes the impact of the late hedging guidance on fair value hedges, but does not address cash flow hedges. Based upon the fact that cash flow hedges were not discussed in conjunction with this Basis for Conclusion, we are assuming that the late hedging guidance is not applicable to cash flow hedges.

We do not believe that the late hedging paragraph should apply to cash flow variability attributable to hedges of movements in the benchmark interest rate. In a hedge of the variable cash flows associated with the movements in the benchmark interest rate, changes in credit spreads do not impact the hedged cash flows.

In the event that the late hedging guidance is applicable to cash flow hedges and the short-cut method is no longer permitted, hedges of certain assets or liabilities with larger credit spreads will not always meet the highly effective criteria when the hypothetical derivative method is utilized to assess ineffectiveness. Per FASB Statement Implementation Issue G7, the hypothetical derivative must satisfy all of the applicable

conditions necessary to qualify for the short-cut method including having terms identical to those of the hedged item. Therefore, as mentioned above, hedges of certain assets with larger credit spreads will not always meet the highly effective criteria.

**Recommendations:**

**Issue 1:**

Because of the potential to cause certain hedges to fail the effectiveness test if the proposed guidance is implemented, we would like to propose that the Board consider modification to the proposal to choose one of the following:

1. Do not implement the proposed changes to paragraph 68e specifically precluding hedges from receiving short-cut if the hedged item is not at par, when E23 is issued.

Or

2. Defer implementing E23 late hedging language until FASB Statement 133 paragraph 21 can be modified to allow filers to remove components of contractual cash flows that are not related to the hedged risk.

**Issue 2:**

We recommend that the proposed Issue No. 23 be modified to clarify that the late hedging paragraph does not apply to cash flow hedges.

If you have any questions regarding the contents of this letter, please contact Alan Close ([aclose1@wi.rr.com](mailto:aclose1@wi.rr.com); 414-327-4192). Thank you in advance for your consideration in this matter.

Sincerely,



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## Example for E23 Exposure Draft\_Final

### Summary

This example was designed to show how asset hedges of specific risk (Benchmark interest rate risk) that are considered effective today under FAS 133 paragraph 68, would fail to be effective using long haul accounting. The reason for this discrepancy falls on the fact all contractual cash flows must be included today per FAS 133 paragraph 21f, even for hedges of specific risk. These two examples show how a 200bp and 300bp contractual cash flow tied to credit risk, causes these asset hedges to fail effectiveness testing for certain periods (see row high lighted in green). If GAAP were to modify FAS 133 paragraph 21f to allow filers to measure effectiveness only considering the cash flows tied to the hedged risk these same assets would continue to pass as they did under pre-E23 guidance (see row highlighted in yellow).

### Key Assumptions and Things to Note:

- All numbers in this example are made up. Curves are all perfectly flat. The market rates used for LIBOR and credit are smoother than history.
- Dollar offset test was used for simplicity (Regression testing would have most likely shown better results)
- Asset purchased in secondary market