



LETTER OF COMMENT NO. 23

Mr. Russel G. Golden  
Director of Technical Application & Implementation Activities  
Financial Accounting Standards Board

Via Email

September 21, 2007

Dear Mr. Golden:

Thank you for the opportunity to comment on the tentative conclusion reached by the FASB Staff in DIG Issue E23, *Issues Involving the Application of the Shortcut Method under Paragraph 68*. We have numerous derivative counterparty clients that seek to apply the Shortcut Method for various interest rate swap hedging relationships. We believe that the guidance in the tentative conclusion reached in Proposed DIG Issue E23 could, from a practical perspective, preclude most companies from applying the Shortcut Method.

We agree with the changes and clarifications made to paragraphs 68, 68(a) and 68(b). However, we do not believe the changes made to paragraph 68(e) are related to the effectiveness of the hedge and will preclude the Shortcut Method for hedging relationships which are actually *more* effective than hedging relationships that would meet the requirements.

#### *Fair Value of the Hedged Item and Late Hedging*

Paragraph 5 of Proposed DIG Issue E23 requires the fair value of a hedged item to be equal to its par value to qualify for the Shortcut method. The reason cited for this change in the basis for conclusions is that the non-par fair value could create hedge ineffectiveness. Based on our quantitative analysis (see Appendix A), we do not believe that the fair value of the hedged item is relevant to whether a hedge is perfectly effective. We found, for example, if a bond is trading at a discount this will *increase* hedge effectiveness in certain circumstances.

In our analysis we examined a hedging relationship consisting of a swap designated as a hedge of a bond with a fixed coupon equivalent to LIBOR + 50bp where the change in fair value of the bond was calculated using a LIBOR flat discount rate. We then compared the hedge effectiveness ratios resulting from various yield curve shifts for three different initial bond prices – par, 99 and 98. Our analysis shows that having a fair value of less than par *increases* hedge effectiveness as credit spreads increase if an entity chooses to calculate the change in value due to benchmark interest rate risk using a LIBOR flat discount rate.

We believe the changes to paragraph 68(e) contained in paragraph 5 of Proposed DIG Issue E23 are an amendment of Statement 133 that will disallow the Shortcut Method for hedging relationships that in some cases are *more* effective than those qualifying for the Shortcut Method.

We agree with the three dissenting Board members that Statement 133 does not currently require the fair value of the hedged item to be equal to its principal amount (which disqualifies hedge transactions that are entered into after the initial issuance of the debt instrument). Like the dissenting Board members, we would not support amending Statement 133 to add the requirements contained in paragraphs 5 and 6 of Proposed DIG Issue E23 to the requirements for application of the Shortcut Method in paragraph 68 of Statement 133.

In addition, we do not believe the timing of swap execution should be a relevant factor in being able to apply the Shortcut Method.

*Revision of Paragraph 68(e) – Terms Must Be Typical*

The revision of paragraph 68(e) of Statement 133 to require the terms of the swap and the hedged item to be **both** typical and not invalidate the assumption of no ineffectiveness could be interpreted to preclude the application of the Shortcut Method when there is any term that creates ineffectiveness such as when a company funds at a rate other than LIBOR flat (which most companies do). Based on the guidance in paragraphs 69 and 70 of Statement 133 it is clear that this is not currently a requirement for applying the Shortcut Method. We believe the FASB should clarify that certain *typical* terms (such as a spread to LIBOR) are permitted when applying the Shortcut Method even if they could invalidate the assumption of no ineffectiveness.

*Revision of Paragraph 68(a)*

In our initial reading of the proposed modifications to paragraph 68(a) it was not clear whether the Shortcut Method would be permitted for hedges of a proportion of the principal amount of a hedged item. It is our understanding that this type of hedging relationship (discussed in DIG Issue E10) could still qualify for the Shortcut Method. We would recommend clarifying the language used to amend paragraph 68(a) as follows (changes in italics):

The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged and the notional amount of the fixed leg of the swap matches the notional amount of the variable leg of the swap throughout the life of the hedging relationship. This requirement also is met if the notional amount of the swap and principal amount of the asset or liability being hedged match for each hedged interest payment for a cash flow hedge or match over the entire term of the interest-bearing asset or liability for a fair value hedge, even if the hedged item amortizes or otherwise adjusts subsequent to

hedge inception. However, a swap contract whose notional amount for each interest payment is based on the estimated rate of unscheduled prepayments (but does not exactly match the outstanding principal of the debt security being hedged) does **not** meet the requirement in this paragraph.

#### *Effective Date*

We believe that Proposed Issue E23 is an amendment of Statement 133 that will necessitate many previously qualifying Shortcut Method hedges to be accounted for under the Long Haul Method. Many companies have not previously applied the Long Haul Method and will need a significant amount of time to research, understand and decide on a Long Haul methodology. In addition, these companies will need to clear these decisions with their external auditors. Given the number of companies and hedging relationships potentially impacted, we do not believe it will be feasible to complete this work in less than 90 days. Therefore, if the FASB finalizes Proposed Issue E23 as currently drafted, we would recommend an effective at least six months, but ideally a year, after issuance.

#### *Grandfathering*

Given the significant amendments to Statement 133 we would recommend the FASB consider grandfathering existing hedging relationships. Without grandfathering, those who are applying the Shortcut Method based on the existing guidance will be penalized unnecessarily and left with the choice of either unwinding their hedges or implementing the Long Haul Method.

If you would like to discuss our comments or any other issues further you can contact me at 212-902-7052 or Nora Joyce at 212-357-8391.

Sincerely,

Timothy J. Bridges  
Managing Director

## LIBOR+50 Issuer, Discounted at LIBOR Flat

Fixed Rate:		6.05					
Floating Spread:		0.50					
Shift	Bond	dBond	Swap	dSwap	Sum	Ratio	
	250	-86,155,903	17,706,998	-17,225,546	-17,271,930	435,068	102.5%
	200	-89,381,849	14,481,052	-14,081,263	-14,127,647	353,405	102.5%
	150	-92,757,667	11,105,234	-10,789,679	-10,836,063	269,171	102.5%
	100	-96,291,003	7,571,898	-7,343,249	-7,389,633	182,265	102.5%
	50	-99,989,915	3,872,986	-3,734,024	-3,780,408	92,578	102.4%
	0	-103,862,901	0	46,384	0	0	
	-50	-107,918,921	-4,056,020	4,006,817	3,960,433	-95,587	102.4%
	-100	-112,167,426	-8,304,525	8,156,607	8,110,223	-194,302	102.4%
	-150	-116,618,387	-12,755,486	12,505,594	12,459,210	-296,276	102.4%
	-200	-121,282,322	-17,419,421	17,064,163	17,017,779	-401,642	102.4%
	-250	-126,170,327	-22,307,426	21,843,273	21,796,889	-510,537	102.3%

Issued  
at Par

Fixed Rate:		5.92					
Floating Spread:		0.38					
Shift	Bond	dBond	Swap	dSwap	Sum	Ratio	
	250	-85,290,447	17,599,604	-17,223,029	-17,269,292	330,312	101.9%
	200	-88,496,310	14,393,741	-14,079,224	-14,125,487	268,254	101.9%
	150	-91,851,376	11,038,675	-10,788,140	-10,834,403	204,272	101.9%
	100	-95,363,262	7,526,789	-7,342,237	-7,388,500	138,289	101.9%
	50	-99,039,997	3,850,054	-3,733,564	-3,779,827	70,227	101.9%
	0	-102,890,051	0	46,263	0	0	
	-50	-106,922,353	-4,032,302	4,006,088	3,959,825	-72,477	101.8%
	-100	-111,146,322	-8,256,271	8,155,237	8,108,974	-147,297	101.8%
	-150	-115,571,895	-12,681,844	12,503,551	12,457,288	-224,556	101.8%
	-200	-120,209,554	-17,319,503	17,061,414	17,015,151	-304,352	101.8%
	-250	-125,070,360	-22,180,309	21,839,781	21,793,518	-386,791	101.8%

Issued  
at 99

Fixed Rate:		5.77					
Floating Spread:		0.23					
Shift	Bond	dBond	Swap	dSwap	Sum	Ratio	
	250	-84,291,844	17,475,688	-17,220,126	-17,266,251	209,437	101.2%
	200	-87,474,535	14,292,997	-14,076,871	-14,122,996	170,001	101.2%
	150	-90,805,656	10,961,876	-10,786,365	-10,832,490	129,386	101.2%
	100	-94,292,790	7,474,742	-7,341,069	-7,387,194	87,548	101.2%
	50	-97,943,938	3,823,594	-3,733,033	-3,779,158	44,436	101.2%
	0	-101,767,532	0	46,125	0	0	
	-50	-105,772,467	-4,004,935	4,005,246	3,959,121	-45,814	101.2%
	-100	-109,968,125	-8,200,593	8,153,656	8,107,531	-93,062	101.1%
	-150	-114,364,404	-12,596,872	12,501,195	12,455,070	-141,802	101.1%
	-200	-118,971,745	-17,204,213	17,058,242	17,012,117	-192,096	101.1%
	-250	-123,801,167	-22,033,635	21,835,752	21,789,627	-244,008	101.1%

Issued  
at 98