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March 2, 2007

LETTER OF COMMENT NO. 28

Mr. Lawrence Smith  
Financial Accounting Standards Board  
Technical Director – File Reference No. 1510-100  
401 Merritt 7  
Norwalk, CT 06856

Re: Proposed Statement of Financial Accounting Standards – Disclosures  
about Derivative Instruments and Hedging Activities—an amendment of  
FASB Statement No. 133

Dear Mr. Smith:

The Clearing House Association L.L.C. (“The Clearing House”), an association of major commercial banks<sup>1</sup>, is pleased to have the opportunity to comment on the Exposure Draft, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133* (the “Proposed Statement”). We support the Board’s efforts to provide enhanced disclosures to address users’ requests for additional transparency on the financial impact of derivatives and the related hedged items. However, we have several key issues with respect to the Proposed Statement:

**Issue No. 1: Understanding the Full Picture**—As a group of financial services firms, we are concerned that the Proposed Statement will result in only a partial (and potentially misleading) picture of an entity’s overall risk profile. Users will not gain a complete understanding of a firm’s usage of derivatives and the corresponding impact on its financial position, results of operations and cash flows without a broader understanding of how derivatives are used to manage risks related to all financial instruments. We would encourage the Board to further discuss this issue with FASAC, the Investor Technical Advisory Council, and the Investor Task Force.

<sup>1</sup> The members of The Clearing House are Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank, National Association; LaSalle Bank, National Association; UBS AG; U.S. Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association.

**Issue No. 2: Proposed Statement Not Designed for Entities with Significant Derivatives Activities**—We understand that the Board’s desire is to issue a standard in short order; we also understand and believe that this standard may be beneficial for entities with limited derivative activities. However, this standard is not designed for firms with sophisticated risk management practices, such as large financial services firms. For example, a large financial services firm may conclude that it needs eight or more separate tables to comply with the technical requirements of the Proposed Statement. Notwithstanding that level of disaggregation, those separate tables may contain highly aggregated data that informationally provides little incremental benefit. While the tables will demonstrate where derivative gains and losses are recognized and in what amounts, they will not provide users with any additional information on the timing, amounts, and uncertainty of future cash flows from derivatives. We urge the Board to hold a series of roundtable meetings with preparers and users of financial statements in the financial services industry to obtain insights into what information users need and want to better understand derivative activities.

**Issue No. 3: Tabular presentation of Notionals and Gains and Losses** —We believe that the Board needs to reconcile the requirements of proposed paragraph 44C to the sample table provided in the application guidance. While we understand that the example provided was not meant to address all possible ways of applying the disclosure requirements of the Proposed Statement, the example is *confusing because it presents gains and losses from derivatives and hedged items in asset positions separately from gains and losses on derivative and hedged items in liability positions*. Paragraph 44C currently requires this breakout for derivative fair values, which we believe is reasonable because that is how amounts are presented on the balance sheet. However, we do not believe that it would be reasonable to present gains and losses in this manner because gains and losses would be reported in the same income statement line item for each column presented by purpose.

**Issue No. 4: Effective Date**—Entities with significant derivative activities will need additional time to make system enhancements necessary to comply with the Proposed Statement. Given the significant disclosure requirements of Statements 157 and 159 that must be performed as well, we think the effective date should be deferred by two years.

**Issue No. 5: International Convergence**—Some of our members prepare their financial statements on the basis of International Financial Reporting Standards (IFRS). IFRS No. 7, *Financial Instruments: Disclosure*, provides a single, comprehensive principles-based standard for all financial instruments. Those members believe that disclosures under that statement will provide a fuller, more comprehensive understanding of how derivatives are used to manage risks as well as provide a better understanding of expected future cash flows associated with derivatives. While we understand that it is not the Board’s objective to converge this project with IFRS 7, we think the Board should fully understand the disclosures IFRS 7 requires for derivative instruments and then discuss how and why the final standard’s requirements differ from those of IFRS 7 in the Basis for Conclusions.

## Scope

Under US GAAP, financial instrument disclosure requirements are currently located in various accounting standards. The structure of those standards has resulted not only in complexity for financial statement preparers trying to manage financial reporting risk, but also in segmented financial instrument disclosures that do not provide a complete picture of how risks are managed through various types of financial instruments. This is especially true for financial services firms whose balance sheets are primarily composed of financial instruments. The Board has an opportunity to consolidate current financial instrument disclosure requirements to reduce the operational burden and financial reporting risk facing preparers. We strongly encourage the Board to hold roundtables consisting of both users and preparers in an effort to clarify user needs and assess preparer constraints in meeting those needs. Based on the above, we hope that the Board will seriously reconsider the scope of this project, especially as it pertains to financial services firms. The remainder of our comments relate to the specific requirements in the Proposed Statement.

## Tabular Disclosures

Generally, we believe that the requirement to present tabular disclosures disaggregated by primary underlying risk, accounting designation and purpose will be operationally challenging to implement for significant users and broker/dealers of derivative instruments. The effort involved to alter our existing reporting systems and processes to provide information at the level of disaggregation required by the Proposed Statement will be significant (especially when considering the Proposed Statement's contemplated effective date). We believe that this will be the case for large financial institutions, derivatives dealers and global corporations with central treasury functions as they typically hold thousands of derivatives with various primary and combined underlying risks. In fact the disclosure requirements (as well as the example provided) appear to have been contemplated for entities with limited use of derivative instruments. While we believe for entities with limited derivative activities the disclosures may provide useful information related to the magnitude of derivative use and how derivative instruments are accounted for, such entities are not the primary holders of derivative instruments.

Based on a preliminary assessment of primary underlying risks, our members believe that they could disclose more than eight primary and dual underlying risk tables, which would be further disaggregated by accounting designation and purpose. That information would be subject to internal control processes related to financial reporting and would be subject to external audit procedures as well. We do not believe that users will be able to utilize that level of disaggregated information. If that information was beneficial to understand how and why an entity uses derivative instruments or how it affects an entity's financial position, results of operation and cash flows, it would already be produced today for risk management purposes.

We believe that the added disclosures will not only prove to be overly burdensome on preparers, but worst of all, potentially misleading to users. As noted above, these tables only tell half the story. Due to the overly complex accounting rules that exist today, many entities actively enter into derivative instruments to hedge economic exposure without applying for hedge accounting. If

economically hedged financial instruments are excluded from the tabular disclosures users will not be able to properly analyze the information provided in these tables.

### **Notionals**

Again, for an entity with limited derivatives activity, there may be some benefit to providing notional information. However, for entities with significant derivative activity disclosing aggregated notional amounts does not provide beneficial information. In many cases disclosing notionals is misleading. For example, hedging cash flow interest rate risk using a series of forward contracts when compared to using an interest rate swap would result in an inflated notional disclosure simply based on the choice of hedging instrument.

### **Fair Values**

While we understand the Board's rationale for requiring fair values to be presented gross in the tabular disclosures, we believe that they should be presented on a net basis as well when those amounts are permitted to be presented net for accounting purposes, particularly since it is the net presentation that will be reflected in the balance sheet. Ideally, the user should be able to reconcile the total fair values of derivative instruments presented in the tables to the amounts reported in the balance sheet. However, based on the gross presentation requirement in the tables, this will not be possible. In comparison, IFRS 7 requires presentation based on the amount that best represents the maximum exposure to credit risk at the reporting date, which is presented net for contracts that qualify for offsetting under IFRS 32 and is therefore consistent with the balance sheet presentation of derivative fair values.

### **Gains and Losses Recognized in Income on Derivative Instruments and Related Hedged Items Held at the End of the Reporting Period**

As previously discussed, we believe that the Board should revise the sample table provided in the application guidance to reflect the actual requirements of paragraph 44C of the Proposed Statement. For each purpose gains and losses should be recorded in the same financial statement line item regardless of whether the fair values of the hedging derivatives are in an asset or a liability position. Therefore, we believe that gains and losses on the derivative instruments should be reported net as should gains and losses on the related hedged items.

### **Gains and Losses Recognized in Income on Derivative Instruments and Related Hedged Items No Longer Held or in a Designated Hedging Relationship at the End of the Reporting Period**

The proposed amendments to paragraph 44C do not clarify how to present gains and losses for derivatives and hedged items where a qualifying hedge relationship existed during the period, but no longer exists at the end of the period. We believe that the language in paragraph A8 addresses the allocation of gains and losses under those circumstances. As such, we recommend that language be moved to paragraph 44C of the Proposed Statement.

We also note that the amendment to paragraph 44C requires that this information be reported on an aggregate basis for each accounting designation. This requirement is supported by paragraph B37 where the Board discusses its decision to require that the tables include an additional line item within each accounting designation category for derivative instruments that existed during the reporting period but are no longer open at the end of the period. However, in the sample tabular presentation provided "Positions no longer open at the end of the period" is presented for each cash flow hedging relationship (i.e., purpose) disclosed in the table. Therefore, we ask that the Board clarify this requirement.

We understand that the Board clarified in paragraph B38 that this disclosure "would enable users of financial statements to analyze separately the effect of derivative activities for the entire reporting period from the effect of derivatives open at period end. This would provide useful information on the effectiveness of hedging strategies in place for the entire period as well as at period end." However, it is not clear why this information would be useful for derivatives that were never designated as hedges under Statement 133 (i.e., trading derivatives or derivatives in economic hedge relationships).

#### **Leverage Factors**

The Proposed Statement should provide more guidance related to the disclosure of the estimated magnitude that leverage factors have on a derivative instrument's notional amounts by primary underlying risk. We request that the Board discuss the rationale for requiring this disclosure, particularly its usefulness in providing an enhanced understanding of how derivative instruments with contingent features affect an entity's financial position, results of operations, and cash flows in the Basis for Conclusions. Perhaps, notional amounts disclosed should be adjusted for the effects of such leverage factors.

#### **Entities That Do Not Apply Hedge Accounting**

The tabular disclosure requirements appear to penalize entities that apply hedge accounting under Statement 133 because the table information required is significantly reduced for derivative instruments that are not designated in qualifying hedge relationships under Statement 133. Additionally, entities that do not apply hedge accounting under Statement 133, but use derivatives in economic hedge relationships would not be required to provide (and in fact would be precluded from providing) information in the tables related to the hedged items. Also, disclosure would not be required for derivative instruments embedded in hybrid financial instruments and for which the entity has chosen the fair value option. Given the overall objectives of the Proposed Statement, it is unclear why such items have been treated in that manner.

#### **Contingent Features**

Use of the term *contingent feature* is too broad for what we believe was the intended meaning. We understand that the Board added this requirement to better understand the consequences of a credit downgrade on liquidity. If that is the Board's intention, then we believe it should be stated as such. If that is not the Board's intention, then we encourage the Board to clarify the meaning of this

paragraph because that term is vague. Further, footnote 12a4 notes that certain contingent features are not contingent features for purposes of the proposed requirement. Such statements make it very difficult to decipher what exactly the Board's intent is.

### **Effective Date**

As discussed above, we understand that the Board has concluded that entities would not need to make major enhancements to their systems in order to comply with the new disclosure requirements. That assumption is certainly plausible for entities with limited derivatives activities; however, for entities with significant derivatives activity, that assertion is not true. This information does not exist at the level of disaggregation required by the Proposed Statement and it will take time to redesign financial reporting systems and processes to conform to the proposed presentation format. In addition, because information pertaining to the income statement would be required for the year ended December 31, 2007 (for calendar year-end companies), the systems and process necessary to capture data will not have existed as of the beginning of the reporting period (January 1, 2007). Also, we would like to remind the Board that our members are currently in the process of adopting Statement 157 and soon will be working to implement Statement 159, both of which include significant additional disclosure requirements. Thus, we do not believe that the proposed effective date is achievable; we strongly suggest that the effective date be delayed by two years.

### **Other**

Paragraph A7 provides allocation guidance related to the tabular disclosure requirements where only a portion of a derivative instrument is designated and qualifying as a hedging instrument. We believe that this guidance is integral to the Proposed Statement and as such, should be included in its main body (ideally in paragraph 44C).

Paragraph B5 contains information regarding the scope of the document as it pertains to hybrid instruments that are required to be separated into a host contract and a derivative instrument under paragraph 12 of Statement 133. We believe this language should be included in the scope section of the Proposed Statement rather than in the Basis for Conclusions.

We appreciate the opportunity to submit our views and would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact Norman R. Nelson, General Counsel at The Clearing House, at (212) 612-9205.

Very truly yours,

