



LETTER OF COMMENT NO. 22

## B&F CAPITAL MARKETS, INC.

August 7, 2008

Financial Accounting Standards Board

Via e-mail to: [director@fasb.org](mailto:director@fasb.org)

File Reference No. 1590-100

### **RE: Exposure Draft for amending FAS 133 Accounting for Hedging Activities**

As a company that works with many small to mid-size users of interest rate derivative products, both financial institutions and their commercial borrowers, we would like to offer the following perspective on the Exposure Draft for amending FAS 133 Accounting for Hedging Activities.

We represent two classes of end-users:

- 1) Regional banks that hedge their fixed rate loans individually by entering into pay-fixed swaps which exactly match the terms of each loan. These swaps are currently designated as fair value hedges of interest rate risk and because the payment dates and notional principal amounts on the loan and the swap match and the floating rate is indexed to Libor (a "benchmark" rate), the swap is eligible for the short-cut method under the current standard and the bank can assume that there will be no ineffectiveness during the term of the transactions.
- 2) Commercial end-users who typically use swaps to hedge their variable rate debt. These borrowers typically enter into pay fixed swaps thereby locking-in a fixed rate. These are currently designated as cash flow hedges of interest rate risk and most qualify for the short-cut method. These end users typically hedge all or a portion of their debt at inception or at a later date (they may not like the level of rates at inception of the debt).

The Exposure Draft issue most relevant to our clients is issue 4. The proposed amendment would eliminate the ability to designate interest rate risk as the hedged risk except for hedges of an entities own debt entered into at inception of the debt.

Under the proposed amendment a bank would not be able to designate interest rate risk as the hedged item in a fair value hedge because their loan asset is not eligible for bifurcation by risk. Therefore, in order to qualify for hedge accounting, the bank must demonstrate, among other things, that changes in the fair value of the swap will be reasonably effective at offsetting changes in the fair value of the loan. This assertion is difficult to make. Because the swap will be transacted in the interbank market and any credit risk to the bank will be supported by highly liquid collateral provided by the counterparty, changes in the swap's fair value are almost exclusively due to changes in interest rates. The fair value of the fixed rate loan is, of course, also dependent upon changes in interest rates; however, it is much more sensitive than

the swap to changes in credit. Both the borrower's credit rating and the value of the underlying collateral will have a significant impact on the fair value of the loan.

Valuing small, unrated commercial loans for credit risk without an active market for these loans or even comparable spread information will introduce a great deal of subjectivity to their valuation and, in our opinion, will actually reduce the transparency of financial results. However, even if the bank were able to assert reasonable effectiveness for the hedge, valuing the hedge for credit risk would increase earnings volatility due to the change in value of the underlying loan relative to the swap.

The proposed amendment changes what started out as a simple way to hedge interest rate risk into a complex process requiring banks to value credit risk, which was not being hedged in the first place. Because banks will not want to increase earnings volatility or go through the complex process of valuing the credit risk of unrated borrowers, the proposed amendment will most likely result in less hedging, with more interest rate risk retained by banks and fewer product choices available to end-users.

For commercial end-users the proposed amendment would only allow interest rate risk to be designated as the hedged risk if the hedge was done at inception. If a swap was entered into prior to inception (e.g. a forward swap to lock a rate on a Construction/Term Loan) or after inception (because market conditions were not attractive at inception), the end-user would instead be required to value both the hedge and the hypothetical derivative based on interest rates and potential credit risk.

As was the case with the bank, the end-user in this case is merely trying to hedge interest rate risk (the risk of rates going up). There is no intention for the swap to eliminate or insure against credit risk. Consequently, under the proposed amendment a burden will be placed upon the end-user to re-value the loan (subjective at best), and will result in more volatility in the income statement.

In both cases illustrated above, the ability to hedge a legitimate business risk (earnings variability due to changing interest rates) will be eliminated or made prohibitively expensive and complex by the proposed amendment. Although interest rate swaps could still be entered into, the difficulty and cost of obtaining fair values as well as the potential for *increased* earnings volatility due to the inapplicability of hedge accounting would likely result in fewer companies opting to hedge.

Transparency in financial reporting is vital to the functioning of the markets; however, we believe that without the implementation of fair-value accounting for all items on the balance sheet, this amendment will make simple hedging transactions too complex to value, impose significant costs to the process, add volatility to the income statement and induce entities to retain more risk as the accounting burden becomes too great to enter into a simple hedge of interest rates.

Regards,

A handwritten signature in black ink, appearing to read "Derek Beitzel", written in a cursive style.

Derek Beitzel  
B&F Capital Markets, Inc.