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Kawaller & Company, LLC
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August 15, 2008



To: Technical Director, FASB
From: Ira Kawaller

LETTER OF COMMENT NO. 63

Re: FAS 133 Exposure Draft – File Reference No. 1590-100

The FASB deserves to be commended on the effort to simplify and improve FAS 133; but all in all, the proposed amendment falls short of achieving those worthwhile goals.

My comments address the four areas that I view as most significant.

Prospective Effectiveness Testing

It appears that the FASB has come to appreciate that reporting entities are having too hard a time to qualify for hedge accounting; and on the face of it, the suggested changes would seem to be lowering the bar to qualify for this treatment. Under the proposed guidance, the reporting entity would be required to offer a “qualitative assessment” that demonstrates that (a) an economic relationship exists between the derivative and the hedged item and (b) that changes in the derivative’s fair value would be *reasonably effective* (italics added for emphasis) in offsetting fair values or cash flows of the designated hedge item. Additionally, the issues would only be re-considered if a material change in the hedge relationship were to occur, calling into question whether the hedge will continue to perform sufficiently well. This language reflects a clear easing with regard to prospective effectiveness testing, as in the existing text, hedges must be expected to be *highly effective* at achieving these offsets with this evaluation required to be repeated no less frequently than quarterly.

Despite the obvious intent, the proposed language is problematic on two points: First, it’s not at all clear how a *qualitative assessment* can demonstrate that a hedge will work sufficiently well. Reliance on a qualitative assessment seems likely to be guidance that’s simply too amorphous to be of much practical value. The uncertainty as to what works and what doesn’t could be eradicated by requiring a quantitative prospective effectiveness test that demonstrates a reasonably high correlation between the prices underlying the derivative and those underlying the exposure.¹ In fact, this correlation proposition was stated in paragraph 75 of the original standard; but in practice, auditing firms have looked for additional (or even alternative) statistical criteria to be satisfied.²

¹ To be fair, the proposal does allow that quantitative assessments might be necessary in “certain cases.” In practice, it’s hard to see how this allowance wouldn’t end up serving as the default requirement.

² Perhaps worth noting, the proposed amendment would delete Paragraph 75 from the Standard, but the same principle appears to be preserved in a revised Paragraph 94.

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The second problem may be semantic, but these standards are read literally and the words have to be right. Specifically, the proposed wording relating to the prospective effectiveness test is that “changes in fair value of the hedging instrument would be reasonably effective in offsetting changes in the hedged item’s fair value,” for fair value hedges; and “changes in fair value of the hedging instrument would be reasonably effective in offsetting the variability in the hedged cash flows,” for cash flow hedges.³ The difficulty with this language is that it appears to ignore derivative settlements. That is, derivative results often consist of two components – changes in cash flows and realized settlements. (Think swaps, as opposed to forward contracts.) Does this guidance mean that the effects of settlements can be ignored? In fact, I would think not, but that’s what the proposed changes seem to say.

This issue could be easily remedied by substituting “the hedging instrument’s gains or losses (inclusive of fair value changes and any settlements)” for “changes in fair value of the hedging instrument.”

Hedging the Benchmark Interest Rate

Except in limited cases, the new rules would require the risk being hedged to be designated as the full fair value or the entire cash flow variability of the hedged item. Benchmark interest rate hedging would still be permissible for fair value hedges on the reporting entities own debt provided these hedges start concurrently with the inception of the debt.

For those precluded from designating the benchmark interest rate as the rate being hedged, this change would almost inevitably foster ineffective results, thus opening the door for the possibility that hedge accounting could be discontinued. For instance, a cash flow hedger exposed to the London Interbank Offered Rate (LIBOR) plus or minus a spread would likely have to record ineffectiveness as a consequence of adjustments to the spread over the life of the hedge. Given that it’s fairly typical for lending arrangement require adjustments in these spreads either periodically or in response to changing credit consideration, this revision would likely effect large numbers of reporting entities.

The problem is even more severe for entities with fixed rate exposures (i.e. fair value hedgers). In this instance, there’s a clear disconnect between what swaps are designed to do, versus what FASB requires as a prerequisite to qualify for hedge accounting. In order to qualify for fair value hedge accounting, the entity must stipulate that it expects the swap results to offset changes in the debt’s fair value. The fact is, swaps don’t do that.

Over the life of a debt security, the change in the fair value will typically be known with certainty from day-one. It will be the difference between the redemption value and the issue value. If the debt is issued at par and redeemed at par, this change in fair value will

³ See proposed Paragraphs 20b(2) and 28b(2).

be zero. The gain or loss on the swap, however, will be the sum of the cash flows paid or received over the life of the swap. That will be whatever it will be, depending on the course of interest rates throughout the hedge; but the prospect of this gain or loss being equal to the change in the fair value of the debt is virtually zero! Will the swap serve to offset the change in the fair value of the debt? No way.

Simply preserving the capacity to hedge benchmark interest rate changes, however, is not sufficient – at least for fair value hedges. The elimination of the shortcut treatment is also troublesome. The shortcut treatment obviates any concern having to do with effectiveness and simply adjusts the carrying value of the hedged item in such a way as to foster the all-in interest expenses or revenues to conform to the economic objectives of the hedge – i.e., a result that is entirely consistent with the goal of swapping from fixed to floating interest rates. Without shortcut, firms have tied themselves in knots trying to demonstrate something to be true that isn't – that the swap's result could be expected to offset the fair value change of the debt do to the risk being hedged. Never have; never will. By eliminating the shortcut option, the proposed amendment really exacerbates an unworkable situation.

There really is an easy fix for this problem. In the classical application of interest rate swaps, when entities use swaps to convert fixed rate debt to floating, their objective relates to prospective cash flows. They care nothing about offsetting fair values. As a consequence, the problem would be solved if the FASB permitted *all* interest rate hedges that relate to future cash flows – whether fixed or floating -- to be accounted for as cash flow hedges, with (effective) gains or losses being recognized in OCI and later reclassified to earnings.

At present, this course of action is not allowed because a prerequisite for cash flow hedging is that the forecasted cash flow designated as the hedged item must be uncertain. That requirement, however, could be (and should be) eliminated. If the economic objective of the hedge is to alter future cash flows, entities should be able to say so and apply an accounting treatment consistent with this view. That would be cash flow hedging. Fair value hedging should be limited to those applications when the economic objective is to compensate for changes in fair value of the hedged item -- for real! With the requirement to apply fair value hedges to *all* circumstances when fixed rate instruments serve as the hedge item, FAS 133 has taken the round peg and crammed it into a square hole.

Impacts on Risk Management Practice

The seeming allowance to designate benchmark interest rate changes as the risk being hedged for a company's own debt when hedged from inception is not nearly as generous as it might seem. Obviously, if nothing changes, the companies that rely on this allowance will largely feel like the amendment didn't change anything. But stuff happens. For instance, the company might find it advantageous to restructure its debt. Doing so, however, would likely force the company to forego designating the benchmark

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rate as the risk being hedged.⁴ I believe this restriction will likely cause managers to ignore available market efficiencies in order to preserve their original accounting treatment. In the aggregate, this effect could be quite costly.

The need for flexibility is equally relevant in connection with the consideration of terminating hedges. The proposed amendment allows firms either to exit from a derivative or to de-designate the hedge relationship leaving the derivative in place provided an offsetting derivative is initiated coincidentally with the de-designation. (Does this second derivative have to be a perfect mirror image of the first? The proposal doesn't specify.) However, if the second approach is taken (which would likely be an attractive course of action if the original contract were a large liability, thereby requiring a large cash payment to exit), the new rules would preclude using the original derivative in any subsequent hedging relationship if hedging were again deemed to be desirable. It's the same economics to terminate a derivative or to cover it. I believe the accounting should respect this equivalence. Again, these new rules would likely bias economic decisions to the detriment of market efficiency.

Software / Programming Implications

One other significant change under the amendment has to do with the process of determining the split between other comprehensive income (OCI) and earnings for hedge results that have some aren't perfect. It's convenient to address this issue with reference to a hypothetical derivative – i.e., a derivative that delivers exactly the gain or loss required to offset the risk being hedged. Currently, the process is asymmetric. That is, ineffective results impact earnings only if the actual derivative's gain or loss is larger than the hypothetical derivative's gain or loss. Under the new approach, ineffectiveness will impact earnings in both directions. Put another way, the OCI allocation will be determined solely on the basis of the hypothetical's result, and the earnings impact will reflect any difference between actual results and hypothetical results, regardless of which is the larger.

Whether this adjustment is an improvement or not is subject to debate. Arguments can be made for both approaches. In any case, a change will necessitate reprogramming spread sheets and/or FAS 133 accounting software, across the board. Significant costs; questionable benefits.

I'd be happy to hear from you if you'd care to discuss any of my comments. Thank you for your consideration.

Respectfully,



⁴ This outcome would seem to be contrary to the spirit of DIG issue G21, which appears to recognize the irrelevance of the lender, per se, when the substitution of one for the other doesn't alter the economics of the exposure.