



LETTER OF COMMENT NO. 64

August 15, 2008

Mr. Russell Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116
File Reference 1590-100

Subject: Comment Letter on Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133*

Dear Mr. Golden:

Wachovia Corporation is pleased to have the opportunity to comment to the Financial Accounting Standards Board (the Board) on the proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133* (the Proposed Statement). Wachovia enters into hedging relationships primarily to manage our exposure to interest rate risk and foreign currency risk. Accordingly, we are very focused on the Board's proposal and although we agree with certain simplification provisions, we strongly object to the significant modifications to the hedge accounting model and other key provisions for the reasons we outline below.

We agree with the Board's efforts to simplify the accounting for hedging activities, improve comparability and provide for a hedge accounting model that is easier for users of financial statements to understand. However, we believe that the Proposed Statement falls short of these objectives and creates more complexities for preparers, while reducing comparability and removing the fundamental foundation of the original standard.

We do not understand why the Board has presented such a drastic change to accounting for hedging activities without the participation of the International Accounting Standards Board (the IASB). In various forms, the Securities Exchange Commission (the SEC) has requested that the Board work to conform its standards with International Financial Reporting Standards (IFRS) to avoid confusion among investors. Given that a primary objective of the Proposed Statement is to improve transparency for the user and that there is a strong possibility, and even probability given the broad US public support, of a shift toward a single set of global accounting standards, we do not understand the singular effort of the Board to overhaul hedge accounting in a manner that is directly contrary to the encouragement of the SEC and creates divergence from the Board's international partners. We believe that the Board's response of relying on the IASB to follow with an identical standard is precarious given recent experiences and may further reduce international convergence and comparability.

We believe that the Proposed Statement represents a detrimental change to current accounting through the removal of the bifurcation-by-risk approach to hedging, which is the foundation of the hedge accounting model established in Statement No. 133. We agree with the Alternative Views prepared by two dissenting Board members in which they explain why the rejection of the bifurcation-by-risk approach will "not represent an improvement in financial reporting." The Alternative Views also states that derivatives in hedging relationships are "generally designed to manage discrete risks" and that the proposed changes "may disqualify some of the most simple, effective hedging strategies." This issue is precisely our concern with the Proposed Statement, as we believe it will largely eliminate our ability to use hedge accounting under our current risk management strategy and hedging approach. Additionally, we believe that the proposed accounting modifications and corresponding changes to our existing risk management strategy and hedging approach will require considerable system and operational conversion costs that may need to be reversed if the SEC mandates the use of IFRS in the next few years.

Therefore, we believe that the Board should reconsider whether the Proposed Statement meets its stated objectives and whether such a Proposed Statement meets the overall objectives of the Board, the SEC and the international accounting community. Further, we would recommend that Statement No. 133 not be amended unless done so through a joint project with the IASB.

Notwithstanding our objection, should the Board decide to issue the amended guidance as proposed, we urge the Board to consider the following recommendations:

- I. Retain the provisions in Statement No. 133 that permit hedging on an individual risk basis
- II. Retain the provisions in Statement No. 133 that permit the de-designation of hedge accounting at a company's discretion
- III. Clarify aspects of the new effectiveness requirements with a specific focus on when a reassessment may be required
- IV. Delay the effective date until December 15, 2010 or refocus efforts toward a joint project with the IASB
- V. Clarify certain transition provisions

I. Bifurcation-by-Risk (Issues 1 and 2)

We strongly disagree with the proposal to eliminate the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. This proposed change in accounting would alter the fundamental foundation of hedge accounting established under Statement No. 133. We do not understand, nor has the Board explained, what market changes or other circumstances necessitate such a severe change to the existing accounting rules. For many reasons, which we will summarize below, this will impair the usefulness of financial statements as well as the comparability and representational faithfulness of financial reporting.

We acknowledge the Board's overall desire for the accounting of all financial instruments at fair value, however, we do not believe that a piecemeal approach of

mandating fair value for additional items on a staggered basis versus allowing a company to optionally elect fair value is the appropriate next step on the path to accomplishing this goal. The Proposed Statement would require entities that use fair value hedge accounting to record any hedged items at fair value, regardless of the risks being hedged by the related hedging instruments. We believe this expansion of the requirement to use fair value would often result in an increase in the amount of net income volatility related to *that portion of the fair value mark that is not hedged, which is often related to credit*. In many cases, the mark related to the credit risk of a hedged asset that would flow through earnings may be economically offset by a corresponding credit mark on an unhedged liability that may not be recorded at fair value, or in the case of deposits, not be eligible for the fair value option under Statement No. 159. Accordingly, we would not view the proposed change as a step towards increased transparency or a faithful representation of the economics of an entity's true risk position.. Further, this provision provides a new manner in which an entity may elect fair value after inception, which is sharply in contrast with the principles established in Statement No. 159.

We reiterate the comment in the Alternative Views (paragraph A54) that in general, derivatives are designed to mitigate a specific, individual risk. As such, the Proposed Statement's requirement that a derivative in a hedging relationship would result in a full fair value adjustment to the hedged item may disqualify "most simple, effective hedging strategies currently in place". We also agree with the comments in the Alternative Views that the same "moral hazard" regarding the fair value adjustments related to an entity's own credit risk will continue under this Proposed Statement, leading to comparability issues as some entities will record gains on their credit rating declines, while others are not adjusting for such changes in fair value simply because they are not *in hedging relationships*.

A particular focus for us relates to the hedging of the benchmark interest rate within a portfolio of loans. As an example, assume a cash flow hedging strategy to hedge

the first interest payments (using an interest rate swap of the benchmark interest rate) on a continually changing portfolio of consumer loans. Under the Proposed Statement, this hedging relationship would only qualify if the expected changes in future cash flows on the portfolio of loans will be reasonably offset by the interest rate swap. The credit risk in a portfolio of consumer loans can vary significantly and is typically comprised of borrowers that do not have an observable credit spread. As a result, we are concerned about the ability to successfully demonstrate that such a hedge strategy is reasonably effective when its intention is simply to manage interest rate risk.

If the hedging relationship described above were deemed to be reasonably effective, the Proposed Statement requires us to record ineffectiveness in earnings related to the credit risk that is unhedged. Financial institutions typically intend to hold such consumer loans until the borrower repays on the loan and will therefore never be economically impacted by the change in credit spreads of a borrower. They will be affected by actual credit loss events and this process has been well established through the allowance for loan losses. By requiring an entity to record ineffectiveness on a cash flow hedge for the expected change in future cash flows resulting from the credit spreads of the borrower creates earnings volatility that is not a faithful representation of the economic cash flows and is misleading to users.

We concur with the Alternative Views and its specific comments regarding the fair value approach and the "moral hazard" presented with regard to the fair value of a company's own debt. Further, we are concerned with the exception that the Board has provided to allow for the hedging of the benchmark interest rate on a company's own debt if such hedging relationship is entered into at the inception of the debt. Though we welcome the exception from the standpoint that it would retain a few of our existing hedging strategies, we believe that such an exception has an unintended consequence of placing bias on long-term debt over short-term or revolving borrowings. The cost to hedge the benchmark interest rate on long-term debt pales in comparison to those

required to hedge short-term debt over the same period of time. Many companies have reduced this cost by entering into rollover strategies focused on a pool of short-term debt instruments (including deposits, repurchase agreements and commercial paper). The Proposed Statement would eliminate this sound risk management approach, requiring a strategy that is more costly and of lower economic value. We do not understand how this benefits preparers, investors or users of financial reporting.

We would recommend that the Board consider an alternative approach to achieving its objective of improving transparency for users of financial statements rather than through the fair value approach proposed. Specifically, it appears under paragraph A36 of the Proposed Statement that one of the greatest challenges that users face is the inability to understand the carrying amount of a hedged item when it is neither historical cost nor fair value. An alternative approach could be found in more transparent disclosures that would require entities to reconcile the historical cost, the fair value and the carrying amount of all hedged assets or liabilities, which would identify the basis adjustments that have been recorded as a result of the hedging relationships.

II. De-designation

We do not support the provisions in the Proposed Statement that remove an entity's ability to de-designate a hedging relationship at will. The right of an entity to de-designate a hedging relationship has become an important component of prudent risk management, allowing an entity to modify their risk strategy when there are significant changes in a pool of assets or liabilities being hedged or other business environment changes such as balance sheet dynamics and interest rate sensitivity position.

As an example, assume a company enters into an interest rate swap to hedge the variability of cash flows on a portfolio of variable-rate (3-month LIBOR) loans. The hedge is established such that the first payments received in the portfolio are offset by the swap. This strategy also anticipates that future changes in the portfolio over the life of

the hedge will result in a net zero (i.e. sales or prepayments will match purchases and new originations). If the entity desires to change its business model due to various credit, interest rate or other market factors, such that the portfolio size is significantly decreased, the Proposed Statement, and the prohibition on de-designation at will, hampers the entity's ability to adjust the hedging relationships. This will result in significant earnings volatility and will handcuff the company's ability to manage its risk exposure.

The Board's response to such circumstances appears to be that an entity should either terminate the swaps or enter into offsetting swaps to limit the over-hedging impact. However, this is a costly endeavor and with prepayments that may be staggered slowly over a weighted-average expected maturity of the loan pool that could last years, multiple terminations or offsetting derivatives may be needed. This would create considerable operational burdens in addition to exorbitant and unnecessary costs.

In a more complex example, companies may find themselves engaged in long-term hedging relationships and develop a new business model or product that may naturally offset some of the risks being hedged. The noted prohibition on de-designation would impair an entity's ability to utilize this natural offset without significant costs to reengineer its hedging strategy.

III. Reassessment of Effectiveness (Issues 4, 5, and 6)

Wachovia supports the attempt of the Board to simplify the requirements of assessing the effectiveness of a hedging relationship. We believe that the principle of "reasonably" effective is well founded in the effort to achieve this objective. However, we are concerned with the operability of this provision.

Specifically, it is unclear, both within the Proposed Statement and through peer and accounting industry discussions to date, how an entity will be able to meet the "reasonably" effective criterion through a qualitative assessment, particularly with the elimination of the bifurcation-by-risk approach. As such, we believe that most hedging

relationships, including the simplest interest rate swaps, will continue to require a quantitative assessment to qualify for hedge accounting due to the unhedged risks.

Further, paragraph 7 of the Proposed Statement indicates that the assessment of effectiveness would only be required at inception unless “circumstances suggest that the hedging relationship may no longer be reasonably effective”. There is an insufficient level of clarity as to what circumstances may suggest that a hedging relationship is no longer effective. For example, the cash flow hedge strategy related to consumer loans previously described, may be considered reasonably effective if the primary risk is interest rate risk and the critical terms of the loans are matched in the interest rate swap. However, given the significant fluctuations in credit risk of the underlying loans, there is no certainty that the strategy would be reasonably effective.

With an assumption that the hedge above is reasonably effective and assuming that none of the critical terms are changed over the life of the hedge, we do not know what circumstances may result in a need to re-assess the effectiveness of the hedging relationship. Would an entity be required to re-assess if a borrower defaulted? Would an entity be required to re-assess if the borrowers’ credit spreads widened? Given the market disruption and credit crisis over the past year, we would be concerned that such market-driven changes may be seen as a circumstance suggesting an entity must re-assess their effectiveness. And with the significant credit volatility that resulted, we believe that many hedging relationships would no longer meet a reasonably effective criterion. This could then further exacerbate a weakened market due to the loss of hedge accounting and the impact to an entity’s risk management approach, which will introduce unanticipated earnings volatility and may present an unintended market or company-specific catastrophe.

It is also worth noting that a broad statement that a re-assessment of reasonable effectiveness is only required when circumstances change could allow for an entity to arbitrarily decide that a circumstance has changed the overall effectiveness of a hedging

strategy as a means to achieve de-designation, especially given the prohibitions established in paragraphs 14 and 15 of the Proposed Statement on de-designation at will.

As such, we would strongly recommend that a subsequent re-assessment of effectiveness only be required if the contractual terms of either the hedging instrument or the hedged item have been changed.

In addition, it is not clear whether a re-assessment of effectiveness would require both a retrospective and a prospective assessment. We believe that only a prospective assessment should be required. If a retrospective assessment would be required, the Proposed Statement should clarify whether retrospective accounting adjustments would be necessary (i.e. whether the “death penalty” would apply).

IV. Effective Date (Issue 8)

The Proposed Statement is a significant amendment to one of the most complex accounting standards in US GAAP. The changes proposed will result in the elimination of most, if not all, existing hedging relationships (often through termination which could flood the marketplace with cancelled derivatives) and the need for companies to create new risk management strategies. Further, the proposals will require adjustments to existing tools and systems for measuring ineffectiveness, and for many companies, the creation of such tools.

Over the next sixteen months, companies will be required to implement the following new and amended standards that have resulted in dramatic accounting changes, with a broad impact on companies that will also be affected by the Proposed Statement:

- Statement No. 141R and Statement No. 160
- Statement No. 161 and proposed Staff Position No. FAS 133-b
- Expected amendments to Statement No. 140 and Interpretation No. 46R

As such, we do not understand why the effective date has been expedited to allow for a period less than one year from its issuance for review and transition. We note that the IASB has set a sensible precedent whereby a standard should not be effective within one year of its issuance. Further, recent congressional input on the efforts to amend Statement No. 140 and Interpretation No. 46R indicate a general discomfort with expediting such substantial accounting changes given the impact such action will have in the market. Therefore, we recommend that the Board delay the effective date to fiscal years ending no sooner than December 15, 2010, or refocus their efforts on this project toward a joint project with the IASB.

V. Transition (Issue 10)

The Proposed Statement significantly reduces the ability for entities to achieve hedge accounting, particularly in relation to portfolios of financial assets or financial liabilities, and therefore broadly affects a company's overall risk management approach. As a result, should the Board decide to go ahead with the issuance of the Proposed Statement as currently drafted, then we believe that the Board should allow a one-time fair value option at the initial adoption of the Proposed Statement for *any* financial asset or liability within the scope of Statement No. 159, not just those currently in hedging relationships.

In the Proposed Statement, paragraph 34 provides transition guidance for the balances in accumulated other comprehensive income for cash flow hedging relationships that are continued under the new standard. However, it is not clear how an entity should account for amounts in accumulated other comprehensive income if a cash flow hedging relationship must be de-designated as a result of the Proposed Statement and is not designated anew. Specifically should these amounts also be recorded directly to retained earnings or should the balance continue to be amortized into earnings under paragraph 31 of Statement No. 133, as long as the forecasted transaction is still expected to occur?

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We would be pleased to address any questions you may have regarding the comments in this letter or to discuss our position in more detail, at your convenience. I can be reached at 704-383-3021, or by email at pete.carlson@wachovia.com.

Sincerely,

Peter M. Carlson
Executive Vice President and
Corporate Controller

cc: Thomas Wurtz, Senior Executive Vice President and Chief Financial Officer