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Mr. Russell G. Golden
Director of Technical Application & Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 99

Re: File Reference Number 1590-100, Proposed Statement of Financial Accounting Standards, Accounting for Hedging Activities, an Amendment of FASB Statement No. 133

Dear Mr. Golden:

We appreciate the opportunity to comment on the Exposure Draft for the Proposed Statement, *Accounting for Hedging Activities—an amendment of FASB Statement No. 133* (the Exposure Draft or “ED”). Citi has participated in and supports the positions taken in the comment letter prepared by the International Swaps and Derivatives Association (ISDA). Beyond the views expressed by the ISDA, this letter focuses on certain issues that Citi wants to highlight further.

We are broadly supportive of the Board’s objectives to reduce complexity associated with hedge accounting and application of SFAS 133. However, we do not support the issuance of the Exposure Draft in its current form and echo the concerns and objections raised in the Alternative Views. As US GAAP reporters anticipate adoption of IFRS in the near- to medium-term future, we believe that the FASB should be working with the IASB to develop more consistent accounting standards rather than issuing a standard that diverges from IFRS and requires significant changes in hedge accounting under US GAAP. Therefore, we believe the Board should drop this project from its agenda.

If the Board decides to proceed with an amendment to SFAS 133, we offer the following comments and suggestions in order to reduce complexity and improve the information about hedge accounting provided to financial statement users.

- Alignment with Risk Management Activities: We do not believe that the proposed amendment is aligned with the hedging activities undertaken in the risk management process, nor does it acknowledge the dynamic nature of hedging as a risk management tool. In order to more properly align hedge accounting with the underlying risk management activities, we suggest the following:

The FASB should continue to permit the designation of component risks: Precluding hedge designation of component risk ignores the hedging practices fundamental to risk management, is predicated on no apparent theoretical basis, and creates potentially significant measurement anomalies. At a minimum, US GAAP’s current practice for designation of component risk should be maintained. In a step toward convergence with



IFRS and reduction of complexity, we suggest that the FASB consider expanding the definition of “interest rate risk” to be consistent with IAS 39, permitting designation of any identifiable interest rate risk that gives rise to changes in cash flows or fair value.

The FASB should remove the requirement for a hedge to be highly or reasonably effective and require only an economic relationship between the hedging instrument and the hedged item: The complexities associated with defining hedge effectiveness at inception and over time are extensive. We recommend that reporting companies need only identify an economic relationship, as described in paragraph 6a of the Exposure Draft, between the hedged item and the hedging instrument at inception.

Ineffectiveness should be measured based on the hedged risk: Measurement of ineffectiveness should incorporate only the risk being hedged. Requiring the hedged item in a fair value hedge to be adjusted for the entire change in fair value, or the present value of the cumulative change in expected future cash flows in a cash flow hedge to mirror 100% of the cash flows is not reflective of the intent in risk management, is without theoretical basis, and presents new complexities for the reporting company and the financial statement user.

Dedesignation and redesignation should be permitted: Dedesignation and redesignation of hedge relationships reflects the dynamic and multi-faceted nature of hedge accounting. While the relationship between the hedged item and the hedging instrument may not have changed in isolation, their relationship keeps changing within the broader context of the reporting company’s risk management activities.

EITF Issue 96-15 should be amended: EITF Issue 96-15, *Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities*, should be amended to require foreign currency gains and losses on available for sale (AFS) debt securities to be recorded in earnings. This would align the US GAAP requirements more closely with those of IAS 39 and eliminate the need for one of the most common hedging strategies in practice which is often implemented in cases where a company has already economically hedged its position by simultaneously holding AFS securities and issuing debt in the same currency.

Our more specific comments on these and additional concerns are presented in the Appendix to this letter. We would be pleased to discuss our views on this Exposure Draft. You may contact me at 212-559-7721.

Very truly yours,

A handwritten signature in cursive script that reads "Robert Traficanti".

Robert Traficanti

Vice President and Deputy Controller



APPENDIX

Convergence with IFRS

We believe the Board should drop this project from its agenda and work with the IASB to develop a single standard governing hedge accounting under both IFRS and US GAAP. As US GAAP reporters anticipate adoption of IFRS in the near- to medium-term, amendments made to SFAS 133 with a view towards convergence with IAS 39 are practical and appropriate. Convergence with IAS 39 improves comparability between US GAAP and IFRS filers, particularly in light of the SEC's elimination of the requirement to reconcile their financial results to US GAAP. However, the amendments proposed by the Exposure Draft represent unnecessary fundamental changes that diverge from IAS 39, are burdensome ahead of the adoption of IFRS and present no incremental improvement to current US GAAP financial reporting. Furthermore, we do not see any indication from the International Accounting Standards Board that it intends to revise IAS 39 in a manner consistent with the Exposure Draft's provisions. Key differences between the Exposure Draft and IAS 39 include:

- i) Precluding designation of component risks of financial hedged items (other than the narrow exceptions described in the Exposure Draft),
- ii) Assessing effectiveness using the "reasonable effectiveness" concept, in the absence of a permitted bifurcation by risk approach, and
- iii) Precluding dedesignation and redesignation of hedge relationships.

We also point out that the Exposure Draft's requirement to record the effects of both under-and over-hedges for cash flow hedging relationships is also divergent from IAS 39 (see paragraph 96 of IAS 39). We have no strong views on the change, but highlight the inconsistency as it appears the FASB considers this a convergence point per paragraph A31.

We suggest that the FASB continue to work with the IASB, as part of its project on reducing complexity for financial instruments, to address any complexity concerns and/or practice issues it feels are particularly prevalent.

Alignment with Risk Management Activities

If the Board decides to proceed with amending SFAS 133, the amendment's provisions should be aligned with the hedging activities undertaken in the risk management process, and acknowledge the dynamic and multi-faceted nature of hedging. We highlight the following five areas where the Exposure Draft's provisions not only disregard the underlying risk management activities, but also add complexity for reporting companies in implementation as well as for financial statement users.

1. The FASB should continue to permit the designation of component risks.

The vast majority of common risk management strategies involve hedging component risks. At June 30, 2008, virtually all of Citigroup's hedges are designated as component risk hedges (only about 0.5% are hedges of overall cash flows and we have no hedges of overall fair value). In eliminating the ability to designate component risks in a hedging relationship, the FASB fails to outline any apparent practice issues. Rather, the FASB simply indicates in appendix paragraph A14 that "constituents also stated that if the Board were to retain hedge accounting, then the only



designated risk permitted to be hedged for all items except an entity's own debt should be changes in overall fair value of the entire hedged item or the risk of overall changes in hedged cash flows." We do not agree with this position and cannot identify a rationale to support this statement.

Market efficiencies have led to the development of widely-standardized hedging instruments such as interest rate swaps. These instruments may be entered into in a very cost efficient manner when compared with the tailored, bespoke instruments which would be required to hedge 100% of the fair value or cash flow changes of hedged items. The very fact that a deep and mature market has developed for these standardized instruments versus other more tailored instruments is indicative of the fact that companies very often want to hedge only certain component risks as part of their risk management process. The data points underlying these well-developed markets, such as that of interest rates, provides a robust statistical data set to support the bifurcation of risks and the mark to market of a hedged item attributable to said risk.

The FASB had already deliberated the topic of hedging component risks and elected to permit component risk designation in earlier versions of SFAS 133. In particular, we point to paragraphs 364 to 366 of SFAS 133's unamended Basis for Conclusions, including the constituent views and the resulting FASB decision. As outlined in those paragraphs, the Board dismissed earlier proposals to reflect the full change in fair value of the hedged item in earnings and "found the focus of respondents *on the earnings impact of the approach to hedge accounting to be persuasive* [emphasis added] and decided to modify the Exposure Draft to focus on the risk being hedged." It is also useful to note that the IASB reaffirmed in July 2008 the hedging of component risk in its amendment to IAS 39, *Eligible Hedged Items*.

As an additional matter, we see no conceptual basis for the Exposure Draft's prohibition against designation of component risks in certain cases (e.g. "late" hedges and assets), while permitting component risk designation in other instances. While we are supportive of the FASB allowing benchmark and other interest rate hedging on a company's own debt, we do not understand the conceptual difference between assets and liabilities in this regard. Further, while we acknowledge the points made in paragraph A19 related to "late" hedging of a company's own liabilities, we believe that companies take a portfolio approach to managing their debt and attempt to achieve a fixed-rate/floating-rate mix that is consistent with its changing risk management objectives. The decision to modify interest rate exposure occurs more frequently than debt issuances. Flexibility to designate interest rate-only risk should align with this economic reality. We do not see a conceptual or practical basis for legitimizing the use of swaps at inception but presuming their purpose is somehow different at a later date. Accordingly, if the FASB is permitting designation of interest rate risk for a company's own debt at inception, we believe that designation of any risk component should be permitted at any time.

As a separate matter, Paragraph A17 of the Exposure Draft states that cash flow hedges of liabilities would have the same results hedging overall cash flows that they would by hedging only the benchmark interest rate. Although this is true for a limited population of cash flow hedge strategies, it is not true for certain types of common cash flow hedge strategies including short-term debt rollovers or hedges involving interest rate locks. In the case of a rollover strategy, a company fixes the variability in interest payments related to changes in benchmark interest rates



associated with the rollover of fixed-rate, short-term debt. This type of strategy is described in DIG Issue G19, *Hedging Interest Rate Risk for the Forecasted Issuances of Fixed-Rate Debt Arising from a Rollover Strategy*. Under the proposed ED, we do not believe that the rollover of these liabilities would meet the narrow designation exception and thus would not be permitted to be designated as a hedge of interest rate risk only. As such, the hypothetical derivative for this hedge relationship would incorporate not only the interest rate risk, but also credit spreads. Current period earnings would therefore include the impact of changes in the company's credit spread over the entire forward term of the hedge relationship. We think this volatility is difficult for users to understand and question the usefulness of recording in earnings the current period impact of changes in, for example, an issuer's 10-year credit spread in a 10-year rollover hedge.

In the case of hedging with interest rate locks, companies often want to lock in their benchmark interest rate for fixed rate debt they are planning to issue in the near to medium term. The Exposure Draft will require companies to measure changes in credit spreads on the forecasted debt issuance and in essence mark these changes in earnings prior to the forecasted debt issuance. Consistent with the discussion on hedging rollovers of short-term debt, we question the usefulness of including in current period earnings the impact of changes in an issuer's forward credit spreads. We further highlight that the offset to the earnings impact of these credit spread changes will be locked in at the time of issuance and amortized into earnings over the life of the issued debt. Recording an upfront impact to earnings, only to amortize the opposite impact over the life of the issued debt, is an operational complexity which does not improve financial reporting for users.

In a step toward convergence, it may be worthwhile for the FASB not only to maintain component designation, but also to broaden the current definition of interest rate risk beyond benchmark rates to include any identifiable interest rate risk index that gives rise to changes in fair value. A common example of this type of interest rate index is the Fed Funds effective rate. This index is not considered a benchmark interest rate under the current definition in FAS 133 and is therefore very difficult for companies to achieve hedge accounting in cases where a highly effective economic hedge is achieved. The Fed Funds effective rate is an identifiable market interest rate index with observable interest rate forward curves which make it relatively straight-forward to value the underlying hedged item for changes in interest rates. Broadening the definition of interest rate risk would make it consistent with IAS 39 and promote accounting results that better reflect the economics of the underlying risk management activities.

2. The FASB should remove the requirement for a hedge to be highly or reasonably effective and require only an economic relationship between the hedging instrument and the hedged item.

We support the FASB's goal of reducing the complexity associated with assessing effectiveness. However, any simplification achieved by a more relaxed effectiveness standard is nullified by the prohibition against hedging component risks. Consistent with the Alternative Views, we believe it will be difficult to qualitatively support effectiveness in cases where overall risk is required to be included in the assessment but only component risks are economically hedged. For example, in an environment where credit spreads are more volatile than interest rates or move in a different direction, it seems unlikely that a company would be able to qualitatively demonstrate that an interest rate swap is reasonably effective at offsetting changes in the overall fair value or cash flows of the hedged item, even though it may be a precise economic hedge of the changes in



interest rates the hedge is designed to mitigate. Consider the following example which demonstrates the impact of credit risk volatility on a Citigroup fixed rate debt hedge relationship. For the quarter ended March 31, 2008, the mark to market of a \$50 million Citigroup debt issuance was comprised of \$2.16 million unrealized loss attributable to interest rate risk and \$2.04 million unrealized gain attributable to credit risk, for a net unrealized loss of \$.12 million.

As an additional complexity in application, credit spreads are often not observable or widely available beyond a select group of companies. Forward curves for credit may be less- or unobservable beyond five years (or shorter periods of time for companies with lesser credit quality). The variance in assumptions and valuation methods when incorporating these risks in the valuation of the hedged item will result in further reduction of consistency and comparability. This is particularly troubling given that, in the majority of cases, the reporting company did not intend to hedge credit risk at all.

In the spirit of a principles-based approach, we recommend that reporting companies need only identify an economic relationship at inception, as described in paragraph 6a of the Exposure Draft, between the hedged item and the hedging instrument. This alleviated burden in establishing effectiveness eliminates the needs for shortcut method and critical term match hedges, areas which have presented implementation challenges and added to complexity. We believe that this proposal also addresses the FASB's concerns about companies using hedge accounting to achieve fair value accounting for items not permitted to be carried at fair value under other literature. To use the FASB's example, there is clearly no economic relationship between the value of a company's tire inventory and an interest rate swap and hedge accounting would not be permitted under the economic-relationship model. Our suggestion further alleviates reassessment difficulties for those situations where a hedge may be a very effective economic hedge over the life of the hedge relationship but perhaps not a perfect earnings offset in individual periods. Risk management is conducted over the life of an exposure; short term disconnects in the earnings relationship of a hedged item and a hedging instrument are not necessarily indicative of an overall effectiveness problem and should not preclude hedge accounting even in those individual periods.

If the FASB does not accept our suggestion to permit designation of component risk, we believe more clarification is required in the use of the term "reasonably effective" and when a qualitative analysis is sufficient. Without further guidance or clarification, we expect similar challenging accounting and implementation issues with the amended SFAS 133 as were experienced with the original issuance of SFAS 133. Accounting firms and regulators formulated rules for effectiveness testing independently outside of the public forum, making consistent and informed implementation and application by preparers difficult.

3. Ineffectiveness should be measured based on the hedged risk.

Consistent with continuing to permit hedging by component risk, measurement of ineffectiveness should incorporate only the risk being hedged. Requiring the present value of the cumulative change in expected future cash flows on the hedged item in a cash flow hedge to mirror 100% of the cash flows or the change in value of the hedged item in a fair value hedge to be based on the entire change in fair value is not reflective of the intent of risk management, is without theoretical basis, and presents new complexities for the reporting company and the financial statement user.



As described earlier, companies often seek only to transform or mitigate select risks, as evidenced by the robust and standardized markets which have developed particularly for interest rate swaps and other interest rate derivative instruments. Requiring ineffectiveness to be measured based on 100% of the changes in the hedged item's fair value disregards the hedging company's intent and often creates, particularly for fair value hedges, significant earnings volatility (please see our earlier example demonstrating the impact of credit risk volatility).

Further, we see no theoretical basis for requiring that the hedged item be reflected at full fair value. Appendix paragraph A16 indicates only that it is valuable for users to understand the risks that an entity does not manage or transform. We support the FASB's intention to make users more aware of relevant risks and expect this can be accomplished through qualitative disclosure. We feel that reporting these risk factors through earnings is without basis. A company that has elected to hedge its interest rate risk and apply hedge accounting will experience materially more volatility and appear "riskier" to the financial statement user when compared with a company that has done no hedging at all. Even if the reporting company has executed a perfectly effective interest rate hedge, it may experience earnings volatility where bifurcation by risk is not permitted. Economically, the hedging company has reduced risk but is penalized with volatility for its risk management decision (or ability) to hedge only interest rate risk. For instruments particularly with volatile credit spreads, this is a significant penalty. In some cases, volatility in credit spreads is so significant as to preclude hedge accounting.

As a separate matter, we welcome the practical approach offered in paragraph 12 of the ED for assessing hedge effectiveness for a group of transactions within a specified time period using a single derivative that settles within a reasonable period of time of the hedged cash flows. However, we disagree with the guidance that the time period is "reasonable" if the difference between the forward rate on the single derivative and the forward rate on the derivative or derivatives that would exactly offset the changes in cash flow of the forecasted transactions is "minimal." Ineffectiveness between the single "actual" forward and the forward or forwards that perfectly offset the hedged risk is not a function of the spread between the forward rates at inception. Rather, ineffectiveness is caused by the change in the spread between the two forward rates over the life of the hedging relationship. It is not economically rational to assume that this spread will remain stable over time simply because they are close at inception. We suggest as an alternative approach that mismatches in timing between the actual forward and the forward or forwards that exactly offset the underlying cash flows can be ignored as long as the hedging company expects that the amount of ineffectiveness in the relationship is minimal.

4. Dedications and redesignation should be permitted.

We are not aware of any current major practice issues, complexities or abuses related to *dedesignations and redesignations of existing hedges*. *Dedications and redesignation of hedge relationships* reflects the dynamic and multi-faceted nature of hedging as a risk management practice. The FASB's basis for conclusions on prohibiting companies from removing the designation of accounting hedges states:

The Board believes that since the economics of the relationship between the hedging instrument and hedged item (forecasted transaction) did not change then the accounting should not change.



The Board acknowledges that entities could override the special accounting under fair value and cash flow hedges by terminating the derivative designated as the hedging instrument and entering into a similar new derivative. However, the Board does not believe that dedesignation should be used as a tool for changing measurement attributes and/or managing the classification of certain items reported in earnings.

Paragraph A11 further supports the prohibition against dedesignation and redesignation on the basis that the economics of the relationship between the hedging instrument and hedged item have not changed. This statement may not be true for relationships with a hedged item that incorporates optionality; changes in the prepayment assumption in a mortgage loan can alter the relationship with the hedging instrument. Even in cases where the relationship between the hedging instrument and the hedged item hasn't changed, the hedge relationship can change in the context of the company's overall financial position and risk management objectives. Given that a company's financial position is dynamic, its risk management practices will be dynamic; hedge accounting should permit dedesignation and redesignation in order to reflect this economic reality.

One cited reason for the FASB to preclude dedesignation is that the FASB believes hedge accounting may be used by companies to achieve fair value measurement for items not currently eligible for fair value measurement and or manage their earnings results. We think this view is incomplete and misrepresents why companies apply hedge accounting in their financial statements. While a company could sometimes technically "manage the classification of certain items reported in earnings," as noted in paragraph A11, a company cannot manage the earnings impact of those items because the future behavior of a derivative's fair value is not known. If a company expected a derivative to lose money over time, it would be more likely to terminate the derivative and avoid economic losses rather than take the economic losses but change the *accounting* for those losses.

While the Exposure Draft does not allow the hedge to be terminated by "merely removing the designation of the hedging relationship" without terminating or selling the existing hedging instrument, paragraph 14 notes that the hedging derivative can be considered to be effectively terminated by entering into another derivative that would offset the future cash flows of the original derivative. If the FASB believes that this method can be used to dedesignate a hedge without actually terminating the hedging instrument, we do not understand why dedesignation by removing the hedge designation should not be allowed. Instead of dedesignating a hedge, keeping the existing derivative and treating it as a trading position after dedesignation, the Exposure Draft allows the same result to be achieved by first entering into a derivative offsetting the original hedging instrument, and then into a separate trading derivative with the same terms as the hedging instrument. Since the same accounting result can be achieved under both alternatives, we fail to understand why the FASB is proposing to disallow companies to follow the first less costly alternative.

In the event that the FASB retains this prohibition against dedesignation and redesignation, we are concerned about the potential impact of effective termination through the execution of an offsetting derivative. Per the Exposure Draft, to effectively terminate a derivative, a company can enter into a mirror image contract leaving the company in its original economic position. We believe this provision will result in mirror image trades being executed to effectively terminate the hedging relationship and immediately reinstate the hedge position. Not only do we expect this



series of transactions may fall under the guidelines in Derivatives Implementation Group Issue K1, "Determining Whether Separate Transactions Should Be Viewed as a Unit," and therefore need to be treated as a single derivative (thus nullifying the hedge termination) but the provision will likely result in form over substance transactions, increasing costs without improving financial reporting or reducing complexity.

5. EITF Issue 96-15 should be amended.

Hedging the foreign currency risk associated with AFS debt securities is a common hedging strategy in practice. In many cases, the hedge is accomplished economically by issuing debt in the same foreign currency. Changes in the value of the issued debt due to foreign currency movements are reflected in earnings under SFAS 52. In contrast, EITF Issue 96-15, *Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities*, requires changes in the value of the AFS security due to foreign currency movements to be reflected in other comprehensive income. To eliminate the differences in earnings recognition, companies often designate the AFS debt security in a fair value hedging relationship. Requiring foreign currency gains/loss associated with the AFS debt security to be reflected in earnings would better reflect the risk management practices most commonly employed, eliminate the anomalies in earnings recognition, and reduce complexity in application. This would remove a significant difference between US GAAP and IAS 39.

Other Concerns

Hedging of Foreign Currency Risk in Intercompany Transactions

Paragraph A38 indicates that the amendments to paragraph 40 of SFAS 133, related to cash flow hedging of forecasted intercompany foreign-currency transactions is necessary to correct differences between the intent of SFAS 133 and how practice has developed. We disagree with this characterization. We believe that these hedging relationships are fully addressed under the current guidance and are not aware of any diversity in practice in this type of hedging (with the exception of hedges of intercompany interest payments as described below). Based on paragraphs 469-471, as well as paragraphs 481-487, it seems the original intent was clear to allow hedge accounting in situations where a consolidated entity would incur expenses in one currency and revenues in another currency from third-parties, but it is not necessary to have a direct relationship between the two transactions. The Board made the decision not to include this strict requirement for forecasted intercompany foreign-currency-denominated transactions because it would have restricted certain hedging strategies for certain intercompany royalty fees and other common hedging strategies. As a result of this guidance, these types of hedging relationships are rarely controversial in practice.

If differences in practice exist, it is most likely limited to hedges of intercompany interest payments related to foreign-currency-denominated intercompany loans. We are not certain whether the FASB's added guidance to paragraph 40 reflects a new stance on the part of the FASB for all types of intercompany hedging relationships or it is intended to address the specific issue of intercompany interest payments. This confusion for the accounting community could lead to more differences in practice, not less, unless this issue is clarified in the proposed guidance. We are also troubled by the lack of public discussion on the hedging of foreign currency risk in intercompany transactions.



Accounting for Options in Cash Flow Hedging Relationships

We disagree with the proposed changes to the accounting for options in cash flow hedging relationships. The initial deferral and then reclassification of option time value on an amortized basis in periods when there is no impact on earnings from the underlying transaction is contrary to many of the basic principles of SFAS 133. There does not appear to be any rationale for why the Board would choose this middle ground for the accounting treatment for options.

We do not understand the statement that this proposed model is consistent with the way “the time value component of a purchased option is accounted for under the foreign currency cash flow model”. We know of no FX hedging relationship where option premium is amortized in the periods prior to when the forecasted transaction impacts consolidated earnings. The amortization of option time value would only occur in the limited and specific case as described in paragraph 30d, footnote 10a, of SFAS 133, when an option is used to hedge an *existing FX-denominated asset or liability*. In this case, the option time value is amortized from OCI to earnings over the period when the SFAS 52 remeasurement gains and losses are being recorded in earnings.

We recommend that the guidance for option time value be consistent with the general approach as currently allowed by DIG Issue G20 and that the FASB consider simply eliminating the words “amortization of the” in the last sentence of A33 and paragraph 26.

Disclosures Upon Transition

Related to disclosures upon transition, we suggest that the FASB require disclosure of the retained earnings impact in cases where the fair value option is elected for items formerly designated as hedged items.