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Mr. Russell Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

File Reference No. 1590-100

Dear Russell:

The American Bankers Association¹ (ABA) appreciates the opportunity to comment on the Board's Proposed Statement of Financial Accounting Standards, Accounting for Hedging Activities – an amendment of FASB Statement No. 133 (the proposal).

ABA supports the Board's objectives in the proposal to: (a) simplify accounting for hedging activities, (b) improve financial reporting of hedging activities to make the accounting model and associated disclosures more useful and easier to understand for users of financial statements, (c) resolve major practice issues related to hedge accounting that have arisen under Statement 133, and (d) address differences resulting from recognition and measurement anomalies between the accounting for derivative instruments and the accounting for hedged items or transactions. However, ABA is concerned that the proposal does not meet these objectives and that it introduces significant new implementation issues that would require extensive further implementation guidance. The proposed changes, including specifically the elimination of the bifurcation-by-risk approach does not significantly simplify the application of Statement of Financial Accounting Standards No. 133, Accounting for Derivative Financial Instruments and Hedging Activities (SFAS 133), and produces accounting results that are inconsistent and not representative of risk management strategies. Additionally, ABA believes that any project on hedging activities should be a joint project with the International Accounting Standards Board (IASB) in light of the recent memorandum of understanding between the FASB and the IASB and goals of convergence. The proposal is expected to have a dramatic impact on the hedging activities of banking institutions of all sizes, and it should not be issued without further educating the industry about the impact of the proposal and an analysis of the impact it will have.

We are very concerned that many in our industry—particularly small and medium size financial institutions—are not aware of the significant consequences of this proposal. Evidence of this can be seen in that the comment letters received by the FASB to date



LETTER OF COMMENT NO. 126

¹ The ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members—the majority of which are banks with less than \$125 million in assets—represent over 95 percent of the industry's \$13.3 trillion in assets and employ more than two million men and women.

include only a few from those institutions. With the current market conditions, financial institutions are focused on other accounting issues, which have, quite frankly, taken their attention away from proposals such as this. This is a major issue that warrants significant attention, and we encourage the FASB to make sure that it has provided constituents with sufficient education on and time to evaluate the proposal.

IFRS Convergence

ABA questions the Board's urgency to issue significant amendments to the hedge model during a time period when the sense of urgency about convergence with International Financial Reporting Standards (IFRS) has heightened. FASB's Alternative Views indicate that it is likely that U.S. public companies will adopt IFRS in the foreseeable future. As many institutions are already investing time and dollars in planning and evaluating IFRS to determine how it may be applied in practice in preparation for its anticipated near-term adoption, ABA agrees with the alternative views indicating it would be unreasonable to ask the participants in the U.S. markets to understand, interpret, and implement this proposal, which is a different form of U.S. GAAP, followed by a change to IFRS in a few years, and then possibly a change in a few more years, depending on the outcome of the IASB's discussion document on accounting for all financial instruments.

Bifurcation-by-Risk

ABA is concerned with the proposal to eliminate the ability to designate individual risks as the hedged risk in a fair value or cash flow hedge other than at initial recognition of a debt instrument. The ability of an entity to achieve expense savings, as described in A18, is not necessarily unique to hedging relationships that are entered into at inception of the debt. Our chief concerns are that the inclusion of unhedged or unhedgable risks will lead to many common hedging strategies no longer qualifying for hedge accounting even under a reasonably effective methodology and, therefore, lead to accounting results that are inconsistent with many companies' interest rate risk management activities. This would result in more complex financial reporting for users and ultimately potential preclusion of certain prudent risk management. Thus, the changes proposed will not support the Board's objectives to simplify hedge accounting and improve financial reporting, and it will conflict with regulatory interests in improving prudential bank management practices.

We are aware that the Board's desire is to account for all financial instruments at fair value; however, the proposed changes do not lead to the reporting of financial instruments at their full fair value. Instead, the proposal significantly increases the complexity and differences in reporting of similar instruments. Concerns regarding unhedged risks and overall risk management strategies should be further addressed through disclosures such as SFAS 107, Disclosures about Fair Value of Financial Instruments, and SFAS 161, Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133.

The inability to bifurcate risk means that when hedging a loan, both interest and credit risks must be considered. We are concerned that the inability to hedge solely interest rate risk under the proposal will lead to either requiring loans to be reported at fair value or not hedging. Neither alternative is good, as it is very difficult to estimate reliable fair values for many loans and because not hedging may lead to increased risk exposure.

Hedging One's Own Credit Risk

ABA believes the requirement to include "own credit risk" in hedges of an entities' own issued debt will significantly limit companies' ability to manage interest rate risk, and will

introduce significant complexities in the hedge accounting model. This requirement will affect entities of all sizes and limit an entity's ability to address changes in interest rates, resulting in financial reporting that is misleading and inconsistent with risk management. ABA is also concerned with consistency in application by entities in measuring their own credit risk. We share the Board's Alternative Views concerns regarding legal considerations, including self-dealing and insider information.

Elimination of Shortcut and Critical Terms Match Methods

ABA is concerned with the proposal to eliminate the shortcut and critical terms match methods of hedge accounting. Many medium sized and smaller institutions are still utilizing these methodologies. The recent issuance of DIG Issue E23, Issues Involving the Application of the Shortcut Method under Paragraph 68, and the FASB's deliberations during this issue, provided increased clarification to ensure that companies are correctly and consistently applying the guidance. The elimination of these methodologies will have a significant impact on certain entities' decisions about whether to continue to apply hedge accounting. Many of the smaller institutions do not have system capabilities or models to apply the "long-haul" method of accounting and would require significant implementation and ongoing costs to apply hedge accounting. The additional costs to these institutions would likely outweigh perceived benefits.

Effectiveness Considerations

The proposed changes would change the effectiveness criterion from highly effective to reasonably effective and require a qualitative analysis at inception with a quantitative analysis required in certain situations. Additionally, the changes would require an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective.

ABA supports the Board's proposal to amend the effectiveness criterion from highly effective to reasonably effective based on a qualitative analysis. We also support the changes to require subsequent effectiveness testing only when circumstances suggest that the hedging relationship may no longer be reasonably effective. However, because of the significant changes proposed to eliminate allowing individual risks as the hedged risk and discontinuance of the shortcut method, ABA is concerned that many hedges that previously qualified under a quantitative highly effective criterion would not remain effective under a reasonably effective standard at inception or on an ongoing basis. Additionally, because many unhedged risks would be introduced, ABA is concerned that without proper clarification of what represents "circumstances" for determining whether a subsequent test is necessary, practice would develop that would become the new ongoing effectiveness test requirement. Therefore, any attempts made to simplify hedge accounting would be eliminated by the significant proposed changes. Notwithstanding these concerns, the ABA recommends that the Board further clarify what circumstances should be considered when evaluating whether a subsequent effectiveness test is required, and we suggest that the Board consider adding language that indicates a subsequent test is deemed necessary only if there has been a change in any of the critical terms that would have an effect on the expectation of effectiveness. Also, ABA recommends that the Board consider adding criteria for determining whether a quantitative evaluation is required at inception.

Cost-Benefit Considerations

There will be significant implementation and ongoing costs that will far outweigh the benefits described in paragraph A44. For preparers, the changes will require substantive time and costs, including re-documenting of previous hedge relationships, developing and

purchasing systems for ongoing accounting and reporting, and developing and testing the new processes. The cost-benefit analysis should consider the impact of new complexities introduced and should consider the costs that have been incurred over the past several years, as the standard has gone through significant implementation guidance in arriving at a point where institutions are now consistently applying hedge accounting. Additionally, the costs to medium and smaller institutions to implement new methodologies may likely be so significant as to preclude the use of future hedge accounting. The loss of hedge accounting or adding yet another layer of complexity or cost could severely hamper the ability of the smaller institutions to manage interest rate risk. Regulatory safety and soundness concerns are also relevant for financial institutions. Risk management strategies are reviewed in great detail by banking regulators, and any lessening of strategies due to inability to perform hedge accounting will likely be of concern.

As indicated earlier, the proposed changes will introduce new complexities to financial reporting that are inconsistent with risk management strategies and will require substantive new implementation guidance. Thus, users will not be able to assess better the effect of hedging activities on an entity's financial statements as the objective would state. Additionally, the unhedged risks and those not managed or transformed by the hedging instrument will not be transparent to the financial statement reader. As discussed previously, ABA believes that information regarding unhedged risks and overall risk management strategies should be addressed through disclosures such as in SFAS 107 and SFAS 161.

Effective Date and Transition

Due to the significance of changes proposed, the projected effective date would not provide enough time for entities to adopt the new hedge model as described in the proposal. These changes will create significant complexities that will require extensive implementation guidance and review. This is at a time when the accounting standard setters have set goals on convergence, and preparers have started to plan for the adoption of unified international reporting standards. The effective date also coincides with the proposed effective date agreed upon by the FASB for its project on amending SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities – a replacement of FASB Statement No. 125, and FASB Interpretation No. 46R, Consolidation of Variable Interest Entities (revised December 2003) - an interpretation of ARB No. 51. The amendments to these standards will require extensive implementation costs and personnel time. As discussed previously, ABA also agrees with the FASB's Alternative Views that it would be unreasonable to ask the participants in the U.S. markets to interpret and implement this proposed statement, change to IFRS, and then possibly change again to a convergent standard. This three-staged implementation would also incur significant costs for financial statement preparers that must be considered when the Board is evaluating the costs and benefits.

Conclusion

While the ABA supports the broad objectives of FASB's project to simplify the accounting and improve the financial reporting for hedging activities, it is concerned that the changes in the Exposure Draft introduce significant new complexities to the hedge model resulting in misleading financial reporting and accounting results inconsistent with risk management strategies. ABA supports the FASB's alternative views that the amendments do not significantly simplify the application of SFAS 133, produce accounting results that are inconsistent with risk management strategies, and add to the differences between SFAS 133 and the international standard on derivatives and hedging.

Thank you for your attention to these comments on this exposure draft. If you have any questions or would like to discuss further, please contact me at 202.663.5318 or dfisher@aba.com.

Sincerely,
Donne J Fisher

Donna Fisher