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April 25, 2011

Ms. Susan M. Cosper
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference Number 2011-175, Invitation to Comment, *Selected Issues about Hedge Accounting*

Dear Ms. Cosper,

The International Swaps and Derivatives Association's (ISDA) Accounting Policy Committee[1] appreciates the opportunity to provide comments and observations on the Financial Accounting Standards Board's ("FASB") Invitation to Comment on *Selected Issues about Hedge Accounting* (the "ITC") which is intended to solicit feedback on the International Accounting Standards Board's ("IASB") proposed changes to International Financial Reporting Standards No. 39, *Financial Instruments: Recognition and Measurement* ("IAS 39"), included in its Exposure Draft on Hedge Accounting (the "Exposure Draft"). We separately have provided comments on the Exposure Draft during the IASB's public comment period and our letter can be found on ISDA's website[2]. This letter (i) reiterates our organization's overall views on the Exposure Draft, (ii) communicates our comments on specific areas of the Exposure Draft that require enhancement to be operational, (iii) communicates how certain of the IASB's proposed amendments could, if embraced by the FASB, improve the current U.S. GAAP hedge accounting model (or where enhancements to the IASB's proposal would aid in resolving practice issues associated with the current U.S. GAAP hedge accounting model), and (iv) addresses the questions for respondents included within the ITC.

[1] ISDA's Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.
[2] http://www2.isda.org/functional-areas/accounting-and-tax/IFRS

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Key messages:

Overall

- A primary objective of the ITC is to solicit feedback as to whether the IASB's proposed hedge accounting model is decision useful and whether its provisions are superior to the proposed amendments to ASC Topic 815 published in the FASB's May 2010 Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*. Generally, ISDA believes that neither proposal is superior. Rather, the ideal hedge accounting model would build on the strengths of both the FASB's and IASB's respective hedge accounting proposals. As discussed more fully below, there are specific components of the IASB's proposal that our members view as significant improvements over the existing U.S. GAAP hedge accounting model. However, there are certain provisions of the IASB's proposal that would increase complexity, such as the concepts of "unbiased", "other than accidental", and rebalancing which we suggest be replaced with the FASB's "reasonably effective" criterion.

- ISDA believes that the ability to hedge a portion of a financial instrument's cash flow under current IFRS is superior to the bifurcation-by-risk model in current U.S. GAAP (which only permits hedging LIBOR or U.S. Treasury risks). Additionally, there are several aspects of the Exposure Draft that represent significant improvements to the current IFRS hedge accounting model and would, if embraced by the FASB, also serve as a vehicle to significantly improve the current U.S. GAAP hedge accounting model (ASC Topic 815, *Derivatives and Hedging*). Noteworthy enhancements to the hedge accounting model that we will discuss more fully within this letter include (i) hedging component risks associated with nonfinancial hedged items, (ii) hedging groups of eligible items and net positions, and (iii) relaxation of the homogeneity criterion for closed groups of financial instrument hedged items.

- While there are aspects of the Exposure Draft that we strongly support, we find other aspects of the Exposure Draft concerning in that they have the potential to (i) make qualifying for hedge accounting more difficult than under current IFRS and U.S. GAAP (e.g., because of the new concepts "no bias", "minimize ineffectiveness", and "other than accidental"), (ii) introduce more complexity and real economic costs into the hedge accounting model (e.g., because of the requirement to rebalance, the accounting for fair value hedges, etc.), (iii) carry forward existing rules within IAS 39 (e.g., sub-LIBOR issue, disallowing hedges of foreign currency-denominated intercompany transactions such as royalties, etc.) and establish new ones that seemingly contradict with certain core objectives of the Exposure Draft (e.g., the inability to hedge net positions whose components impact earnings in different periods), and (iv) require companies to report the results of a hedge that may not reflect an entity's economic risk management objectives.

- Certain of the Exposure Draft's core principles are conceptually difficult to understand, and because they are not clearly articulated and illustrated, could be interpreted differently by practitioners, independent auditors, and regulators. The principles we find most difficult to understand include how risk management and hedge accounting must be linked, how changes in risk management must be dealt with, the meaning of "no bias", "minimize ineffectiveness", "other than accidental", and when rebalancing versus discontinuation of a hedge accounting relationship is required.

- The Exposure Draft does not provide a practical/operational solution for hedging credit risk, which we find to be a major shortcoming.

- The Exposure Draft prohibits written options, even if combined with a purchased option at their inception, from qualifying for hedge accounting; this represents a change to current practice and creates a rule that is inconsistent with risk management.

Objective of Hedge Accounting

We support the IASB's intent to better align risk management with hedge accounting; however, the requirement to link an entity's risk management objectives and hedge accounting is not illustrated in the Exposure Draft and therefore we are uncertain when and how changes in an entity's risk management practices should be reflected in its hedge accounting results. The Exposure Draft is written in a way that assumes risk management objectives are documented at a micro level and that risk management policies can contemplate all possible changes in an entity's risk profile. Because risk management policies are intended to address risk management activities at a higher level than individual transactions and hedge accounting is applied at the transaction level, the proposal could have unintended consequences including introducing new complexity to financial reporting. Most corporate risk management policies are guidelines rather than detailed rules, which are supported by transaction-specific risk management objectives with detailed hedge designations and analyses.

Additionally, despite the Exposure Draft's aim to better align an entity's risk management objectives and hedge accounting, the Exposure Draft precludes the application of hedge accounting to certain common economic hedge strategies that reflect actual risk management (e.g., hedging credit risk, hedging an entity's net exposure to groups of foreign currency-denominated transactions that impact earnings in different reporting periods, hedging the foreign currency exposure of net income of a consolidated foreign subsidiary, hedging diesel costs nationwide rather than by the pump, etc.). We find this to be a significant shortcoming within the proposal.

Assessment of Hedge Effectiveness

We support the IASB's proposed elimination of the 80-125% "bright line" used to determine whether a hedge qualifies for hedge accounting under IAS 39 and the requirement to perform a quantitative assessment of hedge effectiveness. However, we have concerns that, as currently drafted, the Exposure Draft's hedge effectiveness requirements could require companies to meet an even higher threshold to qualify for hedge accounting than is required under current IFRS and U.S. GAAP (even though the Exposure Draft suggests that it was not the intent of the Board to do so).

The concepts of "unbiased" and "minimize ineffectiveness" are not defined within the Exposure Draft and those concepts generally do not align with most companies' risk management strategies; thus, it is likely that different interpretations of unbiased will emerge in practice which may create an area within the hedge accounting literature that is subject to "second guessing" by auditors and regulators. This outcome is counterintuitive to the IASB's objectives of reducing complexity and could result in inconsistent accounting among companies that consummate the same risk management and hedge accounting strategies depending on auditor interpretation. One possible, yet extreme, interpretation of unbiased is that a hedge accounting relationship must be entirely free from bias (that is, an expectation of zero ineffectiveness) at inception and at each subsequent date an assessment of hedge effectiveness is performed, and that action must be taken by management to minimize ineffectiveness, regardless of cost and/or operational inefficiency.

The objective of hedge effectiveness, as discussed in the Exposure Draft, creates a presumption that the minimization of ineffectiveness is a risk management objective. However, risk management objectives often seek to reduce or transform certain risks within a company's approved risk parameters. In many cases, economic hedges are executed so that transaction risks are eliminated in a manner that complies with a company's overall risk management strategy. In many cases, however, transaction level risks entail some degree of ineffectiveness such as basis risk. Also, companies evaluate the cost, availability, and interchangeability of hedging instruments relative to the benefits of minimizing ineffectiveness; in many cases cost-benefit constraints may dictate the hedging instrument selected. The requirement for a hedge to be unbiased may provide companies incentive to select less cost-beneficial hedging instruments.

To make the Exposure Draft operational, we would recommend that the concepts/phrases "unbiased", "minimize ineffectiveness", and "other than accidental" be deleted entirely and replaced with a principle akin to the "reasonably effective" hedge qualification criterion included in the FASB's exposure draft on *Financial Instruments*. This also would be a catalyst for achieving convergence between the IASB's and FASB's proposed hedge accounting models.

Rebalancing

We support the proposal within the Exposure Draft that would enable companies to modify a hedge accounting relationship (e.g., change in the derivative or hedged item) to be based on their risk management objectives in order to improve the economic offset without requiring the administrative burden of dedesignating and redesignating the hedge; however, we do not support the requirement to rebalance a hedge accounting relationship. As the initial application of hedge accounting is elective we are of the view that companies should be permitted to choose whether to continue to apply hedge accounting—therefore companies should not be required to continue to ensure hedges qualify by rebalancing. In other words, we believe that the hedge accounting model should be symmetrical—designation and dedesignation should both be elective.

The Exposure Draft's rebalancing requirements introduce an added level of operational and reporting complexity. Additionally, the Exposure Draft would seemingly require changes to an accounting hedge even when there is not a corresponding change to an economic hedge pursuant to an entity's risk management strategy. Therefore, the rebalancing requirements run counter to the objectives of the Exposure Draft.

Rebalancing is discussed almost entirely in the context of an increase or decrease in volume/quantity of the hedging instrument and/or hedged item. While changes in volume or quantity of the hedging instrument and/or hedged item may be a common reason for why rebalancing of a hedge accounting relationship may be required, there are a variety of other scenarios where rebalancing might be appropriate. However, the Exposure Draft is void of any articulation of other situations when rebalancing is required (or when hedge accounting must be discontinued), which raises questions regarding the Board's intent; therefore, in order for the Exposure Draft's guidance to be fully useful and operational, additional situations that would require rebalancing would need to be included in the final standard.

The requirement to rebalance could require significant changes to processes, data, controls, and disclosures. The impact of rebalancing on the "lower of" test for cash flow hedges and the need to amortize fair value hedge adjustments should not be underestimated. As such in order for the proposal to be operational and meet the most basic of cost-benefit tests, we strongly recommend that a practical threshold for how much basis risk a hedge can have in its design.

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Voluntary Dedesignation

The Exposure Draft prohibits voluntary termination of a hedge accounting relationship, in part, because of the proposed requirement to rebalance based on an entity's risk management objectives. While we believe the Board's concerns regarding voluntary termination may be alleviated, in part, by replacing the concepts of "no bias" and "minimize ineffectiveness" with "reasonably effective", we strongly disagree with prohibiting voluntary terminations as the initial application of hedge accounting is voluntary and an entity may have valid reasons for choosing to cease applying hedge accounting. Enhanced disclosure about why companies dedesignate or redesignate hedging relationships is the most appropriate way to address any concerns that users or the standard setters have.

The need to voluntarily terminate a hedge accounting relationship may stem from management's decision to alter an economic hedge that does not reflect the accounting hedge designation. In practice, many companies group related exposures (i.e., net interest exposure resulting from a group of interest-bearing assets and related funding sources) in order to determine what risks should be hedged. Current IFRS, and even the Exposure Draft in certain cases, does not allow an entity to hedge on a macro basis (i.e., based on the risk within a portfolio of financial assets and liabilities), but rather at a transaction level. We acknowledge; however, there is additional work planned by the IASB on macro hedging of open portfolios and would support the FASB's involvement in this phase of the hedging project. Generally, a transaction is selected to represent the total risk exposure for hedge accounting designation purposes. As changes occur in the risk profile of the underlying grouped exposure, companies will commonly add new hedging relationships and remove, or dedesignate, existing hedge relationships. Such risk management strategies are prudent and appropriate.

Lastly, our membership is not aware of any abuse in this area. We question the need for this rule, which is not based on a principle but rather on a perceived but undocumented abuse in practice. Furthermore, while ISDA does not support the addition of new rules to the hedge accounting model, if rules are proposed they should be neutral and not be built around (and biased towards) enforcement of perceived abuses in practice.

Hedging of Credit Risk

We do not support the prohibition within the Exposure Draft against hedge accounting for credit risk associated with a financial instrument. Not only does this eliminate an eligible hedged risk within IAS 39, but it also creates a rule that is inconsistent with the objectives of the Exposure Draft—to align risk management with hedge accounting. While we acknowledge that there are concerns regarding the reliability of measuring changes in credit risk, the current fair value measurement and disclosure standards require changes in own or counterparty credit risk to be included in fair value measurements of a multitude of financial instruments—from simple ones to the most complex. Therefore, we find the basis for this rule unsubstantiated, inconsistent, and inappropriate.

Credit hedging is a key risk management activity for many of our members and therefore it is essential that a practical solution is identified. If the final standard prohibits designating credit risk as a component of a financial instrument's overall cash flow or fair value, we would support alternative #3 in the Exposure Draft, which is similar to one of the approaches that we have discussed in our response to Question #7 below.

As a way of expanding the ability to hedge credit risk under the Exposure Draft, we believe that designation of credit risk hedges that are intended to replace cash flows that are otherwise due to be paid but which default should be able to qualify under the cash flow hedge model as this reduces the variability of cash flows. The probability requirement for forecasted transactions should be interpreted in this case to be that the flows under the derivative are probable of occurring should there be a default and loss of cash flows on the hedged item (due to default).

Fair Value Hedges – Measurement of Ineffectiveness – Mechanics and Presentation

We do not support the proposed changes to how and where the results of fair value hedges are recognized in the financial statements as these changes introduce unnecessary complexity to the fair value hedge accounting model. While we do not disagree that it would be useful to show the impact of all hedging activity in one place, we think that it would be more appropriate to do this in the notes to the accounts rather than by grossing up OCI. In addition, we do not support the inclusion of fair value hedge adjustments in separate line items within the face of the statement of financial position. This will lead to additional complexity of the primary statements and likely lead to confusion. Once again, we believe that this is best addressed through disclosure.

We are supportive of the IASB's apparent proposal to allow the use of a hypothetical derivative when assessing ineffectiveness for fair values hedges. We have some concerns however with respect to the implementation of this pragmatic and reasonable approach. Paragraphs B44 and BC105 attempt to permit companies to use a hypothetical derivative when assessing effectiveness and measuring ineffectiveness associated with a fair value hedge; however, these paragraphs implicitly limit the application of this approach to situations where the application of a different method would not produce a different outcome. As discussed in B82 certain fair value hedges merely convert a financial instrument's cash flows from fixed to floating and therefore there should not be any additional conditions for using a hypothetical derivative other than (i) the critical terms of the hedging instrument and hedged item match and (ii) the hedging instrument be at market at the time of designation. This would go a long way to reducing complexity in this area, particularly for interest rate hedges.

Lastly, prior to the FASB's issuance of an Exposure Draft in which it eliminates the shortcut method of assessing hedge effectiveness, it should conduct substantial field testing of the long haul method of assessing and measuring hedge effectiveness for hedges of interest rate risk as there are a number of practice issues that have not been addressed since the issuance of SFAS 133. These issues include the following:

- Recognition of elements of the hedging instrument at the inception of the hedge accounting relationship such as the cost of credit in the hedging derivative,
- Recognition/amortization of the premium/discount on the hedged item as of the inception of the hedge accounting relationship (when hedged after initial recognition/late hedge),
- Amortization of basis adjustments made to the hedged item, and
- Recognition of yields on the hedged item which are not reflective of the entity's risk management objectives.

Without field testing the above issues, the effort to simplify and improve the reporting of hedge accounting will not be complete. ISDA would be happy to assist the FASB with its field testing or other due process to improve the hedge accounting model.

Sub-LIBOR Rule

We do not agree with the retention of the rule in current IFRS that precludes an entity from being able to designate interest rate risk as the hedged risk associated with financial assets or liabilities that bear interest at a contractual rate that is below the designated interest rate (e.g. LIBOR). Entity's that are rated AAA routinely borrow at sub-LIBOR rates yet are still exposed to changes in LIBOR. This prohibition

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creates a rule that contradicts the core principles underpinning the Exposure Draft that hedge accounting should reflect an entity's risk management strategy. Therefore, we find the inability to hedge a specified interest rate that is greater than the contractual interest rate of the hedged item to be concerning. While this prohibition also creates a difference between U.S. GAAP and IFRS (current and proposed), we strongly support the current U.S. GAAP approach and would not be supportive of a change to the IASB approach even if this would enhance convergence. In order to achieve the objectives of the IASB's Exposure Draft this rule should be eliminated altogether.

Within the remainder of this letter we have provided our responses to the questions included within the ITC and additional concerns regarding certain hedge accounting issues for which the FASB did not specifically solicit feedback in the ITC. We hope you find ISDA's comments informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter please do not hesitate to contact the undersigned. Additionally, ISDA would welcome the opportunity to meet with the FASB to discuss opportunities for improving and simplifying its current hedge accounting model as it begins its redeliberations on the project.

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Section I: Concerns Regarding Specific Exposure Draft Provisions

1. Written Options

We request that the requirements in paragraph 11 of the Exposure Draft be clarified, such that individual written options are not excluded from being eligible hedging instruments if combined with other derivatives such that the combination is not a net written option. We believe that the net-written option criterion should only apply to the combined hedging instrument. In particular, many collars are documented as separate caps and floors. As currently written, the guidance in the Exposure Draft could preclude hedge accounting with collars in some circumstances. We also believe that the current FASB rules regarding written options as hedging instruments when offsetting a purchased option embedded in a cash instrument should be retained. Examples of hedging strategies which are dependent on retention of this requirement are hedging callable bonds with cancellable swaps.

Section II: Responses to FASB's Questions for Respondents

Question 1 When an entity uses financial instruments to manage risk exposures in economic hedges but those instruments are not designated in hedging relationships for accounting purposes, do you believe that the proposed guidance would provide useful information about all of the effects of an entity's risk management objectives?

The proposed disclosures within the Exposure Draft as well as those required under IFRS 7 could enable financial statement users to obtain an understanding of the breadth and manner in which companies manage risks. However, there are inherent limitations and risks in providing excessive information about activity within a business as there is a certain level at which the amount of information begins to detract from core purpose for which it was intended.

The disclosure requirements in paragraphs 49 through 52 of the Exposure Draft appear to cover only hedges that are designated in qualifying hedge accounting relationships. As such, it is unclear whether the same disclosure requirements are applicable to economic hedges that do not qualify for hedge accounting. If the aforesaid disclosures are required only for hedges that are designated in qualifying hedge accounting relationships, then there will be certain aspects of an entity's risk management objectives that will not be disclosed.

ISDA also recommends that the FASB and IASB address income statement classification of derivative gains and losses including those that relate to derivatives that are designated in hedge accounting relationships as well as those that are not designated in hedge accounting relationships but which are hedging actual economic exposures. Preparers should be given the flexibility to classify derivative gains/losses associated with economic hedges in the income statement in a logical fashion combined with adequate disclosure in the footnotes rather than simply recording all such amounts in income statement line items that capture miscellaneous income/expense.

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> Question 2
>
> Do you believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?

We support the IASB's intent to better align risk management with hedge accounting; however, the requirement to link an entity's risk management objectives and hedge accounting is not illustrated in the Exposure Draft and therefore we are uncertain how changes in an entity's risk management practices should be reflected in its hedge accounting results. The Exposure Draft is written in a way that assumes risk management objectives are documented at a micro level and that risk management policies can contemplate all possible changes in an entity's risk profile. Because risk management policies are intended to address risk management activities at a higher level than individual transactions and hedge accounting is applied at the transaction level, the proposal could have unintended consequences including introducing new complexity to financial reporting. Take for example a situation where an entity's documented risk management strategy requires it to eliminate 80% of exposure to LIBOR. Assume the entity forecasts that it will issue $100.0 million of 3-month LIBOR-based debt in 1 year and, at that time, the entity executes a $80.0 million notional, pay-fixed, receive 3-month LIBOR forward start swap that will begin accruing cash flow in the month in which the entity issues the debt and designates that swap as a cash flow hedge of variability in 3-month LIBOR. One month prior to issuing the debt the entity alters its overall risk management strategy and issues $100.0 million of 1-month LIBOR debt.

Based on the Exposure Draft we are unclear how this change in risk management strategy would be dealt with. We think there are at least three possible outcomes based on reasonable application of the Exposure Draft:

(1) a new risk management strategy, thereby requiring the termination of the hedging relationship,
(2) a change in the hedge ratio requiring "rebalancing," or
(3) the introduction of no new bias (in either direction) and therefore requires no action other than the measurement of hedge ineffectiveness.

Another issue that the Exposure Draft does not address is how risk management strategies that provide general guidelines as to how certain risks can be managed such as hedging within certain ranges would fit within the model. For instance, a reporting entity may wish to eliminate its exposure to LIBOR with respect to 50% to 75% of its outstanding variable rate debt portfolio. Given the Exposure Draft's proposal to require dedesignation of hedge accounting relationships that deviate from management's originally document risk management objectives, we question how the model would apply to the aforesaid risk management strategy. As this is a fairly common risk management strategy, we strongly recommend that further due process be conducted on this issue prior to the issuance of a final standard.

Additionally, despite the Exposure Draft's aim to better align an entity's risk management objectives and hedge accounting, the Exposure Draft precludes the application of hedge accounting to certain common economic hedge strategies that reflect actual risk management (e.g., hedging credit risk, hedging an entity's net exposure to groups of foreign currency-denominated transactions that impact earnings in different reporting periods, hedging the foreign currency risk of net income of a consolidated foreign subsidiary, etc.). We find this to be a significant shortcoming within the proposal.

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Question 3

Do you foresee an entity changing how it determines, documents, and oversees its risk management objectives as a result of this proposed guidance? If yes, what changes do you foresee? Do you foresee any significant difficulties that an entity would likely encounter in establishing the controls related to complying with the proposed guidance?

We do not agree with the requirement to document risk management strategies at the transaction level. While many risk management objectives are contemplated and executed at the individual transaction level, in many cases risk management strategies seek to minimize risk at a higher macro level. For this guidance to be workable and to not significantly change the way entities view and document risk management objectives, it would need to permit risk management strategies and hedge relationships to reflect the way entities view their businesses.

We foresee that entities that utilize hedge accounting will need to redefine their risk management strategies to better align with the hedge accounting relationships they wish to execute. This will result in the accounting for hedges driving the types of risk management strategies companies transact; not the opposite situation, as we believe was intended by the IASB. This issue is especially relevant to multi-national companies that have decentralized treasury and risk management structures. The establishment of controls for such entities at the subsidiary level may not be feasible or consistent with overall risk management objectives at the consolidated level.

Question 4

Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity's risk management strategies measurable and objective? Could the inclusion of an entity's risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of an entity's risk management objectives?

Our members have concerns that the alignment of hedge accounting with risk management strategies will create an increased risk of being second guessed by auditors and regulators and the like. We have concerns that because risk management strategies often are documented broadly rather than based on specific transactions that any deviation in management's perceived risk management objectives will call into question management's intent. Also, documented risk management objectives cannot reasonably contemplate changes in market conditions (especially when risk management objectives are established at a more "global" level within an organization). As such, we have additional concerns that any deviation from an entity's documented risk management objectives potentially could lead to "tainting" and preclude an entity from applying hedge accounting for similar transactions in the future. Additionally, ISDA believes that entities should have the flexibility to change risk management objectives, within reason, to reflect changes in market conditions without requiring the dedesignation of previously designated hedge accounting relationships.

Another point of concern is that risk management strategies may not perfectly align with the types of hedges and hedging instruments that companies utilize based on market availability of products or related costs. As such, reporting entities may modify their documented risk management strategies in such a way that they deviate from their original, intended strategy but meet the criteria for applying hedge accounting (i.e., the hedging relationship aligns with the risk management strategy). We are unclear what impact tailoring an entity's risk management strategy to comply with transactional hedges will have on its ability to continue to qualify for hedge accounting.

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Question 5
Should cash instruments be eligible to be designated as hedging instruments? Why or why not? If yes, is there sufficient rigor to prevent an entity from circumventing the classification and measurement guidance in other relevant accounting guidance (for example, IFRS 9, *Financial Instruments*, and IAS 21, *The Effects of Changes in Foreign Exchange Rates*)? Are there any operational concerns about designating cash instruments (such as items within a portfolio of receivables) as hedging instruments?

We support being able to use non-derivative financial instruments measured at fair value through profit or loss as eligible hedging instruments. While we do not believe that non-derivative financial instruments will be utilized frequently for hedge accounting purposes, the ability to utilize such instruments would be a useful option for purposes of hedging exposure to changes in foreign exchange rates related to foreign currency-denominated financial instruments that are classified as at fair value through OCI under U.S. GAAP.

Question 6
Do you believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item (for example, equity instruments measured at fair value through profit or loss, standalone derivatives, hybrid instruments, and components of instruments measured at fair value through profit or loss that are not permitted to be bifurcated)? If not, what additional guidance should be provided?

We do not interpret the Exposure Draft as requiring a similarity/homogeneity test prior to designating a group of nonfinancial items together as a single hedged item (e.g., purchases of on-the-road retail unleaded gasoline or diesel fuel); however, we recommend that the Exposure Draft explicitly state this is not a requirement as this has been an area of debate and diversity in practice since the hedge accounting standards were developed.

The Exposure Draft is not clear as to whether or not a host debt instrument that has bifurcated embedded features would be an eligible hedged item. We believe that if the host contract is accounted for separately from derivative components then the host contract should be an eligible hedged item similar to the current hedge accounting model.

Question 7
Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided.

Overall

In general, we support the proposed bifurcation-by-risk principles within the Exposure Draft. However, we believe that prohibiting certain risks (e.g., credit risk) from being hedged as separate risk components not only conflicts with the underpinnings of the Exposure Draft but also will inevitably lead to a rules based approach as other risks either become deemed eligible or ineligible in practice. Overall, we believe that if a risk component is contractually specified then it should automatically meet both the "separately

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identifiable" and "reliably measure" criteria unless the identified risk is very unique (or its determination was proprietary), in which case, an entity would need to ensure that the risk can be reliably measured.

Interest Rate Risk

We do not agree with the retention of the rule in current IFRS that precludes an entity from being able to designate interest rate risk as the hedged risk associated with financial assets or liabilities that bear interest at a contractual rate that is below the designated interest rate (e.g. LIBOR). Entities that are rated AAA routinely borrow at sub-LIBOR rates yet are still exposed to changes in LIBOR. This prohibition creates a rule that contradicts the core principles underlying the Exposure Draft that hedge accounting should reflect an entity's risk management strategy. Therefore, we find the inability to hedge a specified interest rate that is greater than the contractual interest rate of the hedged item to be concerning. In our view, the bifurcation-by-risk rules within the Exposure Draft tend to have a bias towards making it easier to hedge components of non-financial items as there is no explicit requirement that the total cash flow of a nonfinancial hedged item be greater than the hedged component risk. In order to achieve the objectives of the Exposure Draft this rule should be eliminated all together.

Lastly, ISDA believes that the ability to hedge a portion of a financial instrument's cash flow under current IFRS is superior to the bifurcation-by-risk model in current U.S. GAAP (which only permits hedging LIBOR or U.S. Treasury risk). Since the issuance of SFAS 133, numerous, liquid interest rate indexes have become available in the derivative market that enable entities to effectively minimize financial risk. However, many of the derivatives products based on nonbenchmark indexes do not qualify for bifurcation-by-risk, which often creates spurious income statement volatility that is not reflective of an entity's risk management objectives. As such, we strongly recommend that the FASB consider eliminating the concept of a benchmark interest rate in its revisions to ASC Topic 815.

Credit Risk

To make the Exposure Draft more useful and better aligned with an entity's risk management strategy entities should be permitted to hedge credit risk to be measured based either on:

(1) market participant assumptions about credit risk, or
(2) (a) for liquid financial instruments, bond/loan spreads, and (b) illiquid financial instruments, sector credit spreads and the obligor's spread above the benchmark rate

We believe this approach is founded on a key principle underpinning the Exposure Draft. If the Boards do not embrace our recommendation above, we would support alternative #3 in the Exposure Draft which permits an entity to elect the fair value option after the initial recognition of the hedged item.

Question 8

Do you believe that "separately identifiable" should be limited to risk components that are contractually specified? Why or why not?

We would not support a requirement that risk components be contractually specified in order to be hedged as there are a number of commercial and financial risks that can be identified based on common market conventions or practices. For example, it is common for jet fuel futures prices to be priced based either on heating oil or crude oil futures (plus a basis), depending on the market. Since the issuance of SFAS 133 and IAS 39, companies that are exposed to a variety of commercial risks have faced adversity in having economic hedges of transparent and measureable nonfinancial risks qualify for hedge accounting

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under U.S. GAAP and IFRS, respectively. As such, the expansion of bifurcation-by-risk for nonfinancial items would go a long way towards improving the link between risk management and accounting.

[Question 9 – Omitted by FASB]

Question 10

Do you believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population? (For example, do you believe that the sale of the last 10,000 widgets sold during a specified period could be designated a layer component in a cash flow hedge?) If not, what additional guidance should be provided?

For cash flows hedges, we feel that the guidance is sufficiently clear. However, for fair value hedges more guidance on the hedging of interest rate risk for layers of portfolios of assets that are prepayable (or that may be settled prior to maturity through a tender offer or a negotiated repurchase) at other than fair value must be provided. There are many debt instruments that provide the obligor to prepay the debt instrument at prices that are not equal to fair value and in many cases in excess of fair value. For example, in many markets it is common for fixed-rate debt instruments to provide the obligor the right to prepay the debt instrument at an amount that would always be in excess of fair value which is generally viewed as a nonsubstantive prepayment option. We would hope that the proposed Exposure Draft would allow an entity to hedge a horizontal (e.g., bottom) layer of such debt in a fair value hedge of interest rate risk. This enhancement would allow entities to designate a specified portion of a hedged item that remains outstanding (after some in the population are prepaid) without having to identify the specific loans or debt instruments that are expected to remain outstanding over the life of the hedging relationship. Such an enhancement to the proposal would reflect an entity's true risk management objectives and is consistent with the principles underlying the IASB's proposal.

Question 11

Do you foresee any operational concerns applying other guidance in IFRS (for example, guidance on impairment, income recognition, or derecognition) to those aggregated positions being hedged? For example, do you foresee any operational concerns arising when an impairment of individual items within a group being hedged occurs? If yes, what concerns do you foresee and how would you alleviate them?

ISDA does not foresee any significant challenges with regard to the ability to hedge group of individual financial instruments and the effects that impairment, derecognition, or accretion/amortization have on the individual items comprising the group. Generally, ISDA would support any consistent, rational, and systemic approach to account for attendant issues related to hedging aggregated positions.

Question 12

Do you believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity's use of derivatives? Why or why not?

Yes, we believe that in conjunction with sufficient disclosure around how an entity hedges aggregated exposures, the ability to hedge aggregated exposures will provide better information about how entities hedge risks to which they are exposed.

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Question 13 Do you believe that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance and satisfy the proposed hedge effectiveness criteria? Why or why not?

We support the IASB's proposal to permit the hedging of a group of cash instruments that offset and qualify as a group. However, for fair value hedges of interest bearing prepayable financial instruments the restriction to hedge a layer (e.g., bottom layer) only if the prepayment option's exercise price is fair value significantly limits the benefits of this guidance. We do not understand the Board's basis for including this restriction in the Exposure Draft, and therefore, recommend that it be removed from the final standard. The retention of this requirement would result in the addition of new rules to the hedge accounting standard.

The Exposure Draft limits net positions of cash flow hedges to where cash flows are expected to occur and affect profit or loss entirely in the same reporting period. This will create a disadvantage for larger reporting entities that issue interim (i.e., quarterly) financial data as compared to entities that only prepare semi-annual or annual financial statements. Additionally, this will disadvantage companies whose transactions occur within close proximity (a few weeks or a month) but not within the same reporting period (e.g., fiscal quarter). As we see this merely as a rule, and not a principle associated with how an entity risk manages its cash flows, we would strongly recommend that this limitation be excluded from the final standard.

Question 14 Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them?

The concept of "other than accidental" can be interpreted differently. We believe the intent underlying the "other than accidental" requirements of the Exposure Draft should be limited to obvious examples (that can be assessed qualitatively) whereby changes to unrelated/unhedged market variables occur by chance (i.e., represent unexpected aberrations) as opposed to changes that occur as a result of incidental correlation. Therefore, we strongly recommend that if the concept of other than accidental is not removed from the final standard there is an explicit statement that permits entities to assess this risk qualitatively.

Question 15 Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness (for example, how to measure the change in the value of the hedged item attributable to the related hedged risk for nonfinancial items)? If not, what additional guidance is needed?

We are supportive of the IASB's efforts to simplify the assessment of hedge effectiveness. Two components of the Exposure Draft that we welcome are a) the proposal to permit a qualitative effectiveness assessment while carrying forward the requirement to record ineffectiveness through earnings and b) the proposal to require the effectiveness assessment to be solely prospective. As actual ineffectiveness will continue to be recorded in profit or loss on a retrospective basis (that is, as incurred), the requirement to assess hedge effectiveness on a prospective basis is logical and pragmatic. However, we believe the guidance set forth the Exposure Draft provides insufficient illustrative examples and details to understand how the proposed requirements regarding the assessment of hedge effectiveness are meant to be applied. Absent more granular application guidance, our concern is there may be significant differences in application from entity to entity with respect to the assessment methods employed and the threshold at which a hedging relationship would no longer be considered effective. We suggest that the IASB incorporate illustrative examples to demonstrate how an entity is a) to assess hedge effectiveness using its management strategy as the main source of information (B38), b) to ascertain when the offset of the hedged item and hedging instrument is "accidental" (B36), and c) to determine when rebalancing is required (B47).

Question 16

Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity's risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them?

We support the proposal within the Exposure Draft that would enable companies to modify a hedge accounting relationship based on their risk management objectives in order to improve the economic offset without requiring the administrative burden of dedesignating and redesignating the hedge; however, we do not support the *requirement* to rebalance a hedge accounting relationship. As the initial application of hedge accounting is elective we are of the view that companies should be permitted to choose whether to continue to apply hedge accounting—therefore companies should not be required to continue to ensure hedges qualify by rebalancing.

Our thoughts above notwithstanding (i.e., if rebalancing remains a requirement), it is unclear when rebalancing would require a dedesignation versus and an adjustment to the hedging relationship to reflect changes in the effectiveness of hedging relationships. The Exposure Draft seems to require changes to an accounting hedge even when there is not a corresponding change to an economic hedge pursuant to an entity's risk management strategy. ISDA regards this lack clarity to be one the most significant shortcomings of the Exposure Draft.

Question 17

Do you foresee any significant operational concerns or constraints relating to the potential need to rebalance the hedging relationship to continue to qualify for hedge accounting? If yes, what concerns or constraints do you foresee and how would you alleviate them?

The Exposure Draft's rebalancing requirements introduce an added level of operational and reporting complexity. The requirement to rebalance a hedge accounting relationship could require significant changes to processes, data, controls, and disclosures. Also, the impact of rebalancing on the "lower of" test for cash flow hedges and the need to amortize fair value hedge adjustments should not be underestimated.

Question 18

Do you believe that capitalizing the time value of an option as a basis adjustment of nonfinancial items (in other words, marking the asset or liability away from market) will improve the information that is provided in an entity's statement of financial position? Why or why not?

ISDA does not object to capitalizing the time value element of an option as part of a nonfinancial item's basis as this would not be conceptually different from capitalizing interest costs associated with construction projects. However, ISDA favors recognizing the time value of an option in OCI and amortizing that time value over the period when the hedged item impacts earnings. Such an approach may alleviate any attendant issues associated with capitalizing time value (i.e., the impairment of nonfinancial items that are "away from market") We would also support recognizing the change in time value associated with purchased options based on the methodology required in ASC Topic 815-20-25-126 (formerly DIG Issue G20).

Question 19

Do you believe that the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more useful information? Why or why not?

We do not support the Exposure Draft's proposal to recognize the gain or loss on the hedging instrument and hedged item in OCI and to then transfer the ineffective portion to profit or loss. Unlike cash flow hedges in which gains or losses associated with the hedged risk/item will impact earnings in future periods, gains or losses associated with the hedged item designated in most fair value hedges impact earnings during the current period. As the IASB noted in BC120, there is a view that the presentation of gains and losses related to fair value and cash flow hedges, respectively, should reflect the underlying economics of the hedging relationship. As such, we do not believe the change would be an improvement to financial reporting and are in support of the continuation of differing presentations for fair value and cash flow hedges.

Question 20

Do you believe that the proposed presentation of a separate line item in the statement of financial position would increase the transparency and the usefulness of the information about an entity's hedging activities? Why or why not?

We do not support the Exposure Draft's proposal that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position. Separately presenting gains and losses associated with the hedged item due to the hedged risk would not provide any additional information that adequate disclosure in the notes to the financial statements does not already provide. Moreover, the Exposure Draft's proposed presentation would likely result in additional complexity in the financial statements especially for entities that have a significant number of fair value hedges.

The requirement within paragraph 26(b) of the Exposure Draft for the separate line item to be presented next to the line item that includes the hedged asset or liability will result in a confusing presentation without improvement to financial reporting. Such presentation will result in negative balances (which are neither assets nor liabilities) on the asset and liability sides of the balance sheet adding complexity to the primary financial statements. We believe that the offset of the hedged item with the hedging instrument designated in a fair value hedge is the best reflection of the entity's risk management strategy and yields a faithful represents of an entity's financial position.

Question 21

Do you believe that there is sufficient guidance to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position with respect to presenting a separate line item in the statement of financial position?

ISDA would need to analyze the results of any field testing of actual transactions prior to providing feedback on this issue.

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Question 22

Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?

As mentioned under Question 2 above, we find that the linkage between an entity's risk management objectives and its hedge accounting strategies needs to be better articulated in the Exposure Draft. Our lack of clarity leads to similar questions with regard to the disclosure requirements. One issue that we do foresee is the challenges in trying to identify any variance between an entity's disclosed risk management strategies and the extent to which that strategy is actually employed through transactional hedges. In many cases, entities seek to minimize (rather than eliminate entirely) their exposure to risks by hedging only a portion of the item that is exposed to the aforesaid risk. Further risk management carried out by transactional hedges may change over time, and therefore, we question the usefulness of including such information in footnote disclosures. If any disclosures are required, we believe that the information should be left to summary information focusing on a qualitative discussion describing how the entity's risk management strategies have been carried out.

Question 23

Do you believe that the changes proposed by the IASB provide a superior starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP or moving toward converging its overall standards on derivatives and hedging activities with the IASB's standards?

There are several aspects of the Exposure Draft that represent significant enhancements to current IFRS (IAS 39) and would, if embraced by the FASB, also serve as significant enhancements to the current U.S. GAAP hedge accounting model (ASC Topic 815). Noteworthy enhancements include (i) hedging component risks associated with nonfinancial hedge items, (ii) hedging groups of eligible items and net positions, and (iii) relaxation of the homogeneity criterion for closed groups of financial instrument hedged items. However, we do not support the retention of the existing limitation in IFRS that prohibits designation of forecasted, intercompany transactions that do not result in a direct third-party/external transaction (e.g., intercompany royalties) on the basis that these transactions do create cash flow risk and earnings volatility within the consolidated organization. The retention of this rule does not lead to an improvement to financial reporting or simplification of hedge accounting.

While there are aspects of the Exposure Draft that we strongly support, we find other aspects of the Exposure Draft concerning in that they have the potential to (i) make qualifying for hedge accounting more difficult than under current IFRS and U.S. GAAP, (ii) introduce more complexity into the hedge accounting model, (iii) carry existing rules within IAS 39 and establish new ones that seemingly contradict with certain of the Exposure Draft's core objectives (e.g., sub-LIBOR issue), and (iv) require companies to report the results of hedges that qualify for hedge accounting in a manner that is inconsistent with the economic risk management objectives.

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Section III: Additional Areas for Consideration

Immediately below we have summarized specific areas for which preparers have faced difficulty in fitting prudent and valid economic hedges into the current U.S. GAAP hedge accounting framework since the issuance of SFAS 133 (as amended). ISDA encourages the FASB to consider these areas in further deliberations regarding hedge accounting and, where possible, incorporate them into any final guidance. The issues below address certain difficulties in applying the current U.S. GAAP hedge accounting framework to hedges of foreign currency risks to which multinational businesses in all industry sectors commonly are exposed. ISDA would be happy to assist the FASB in developing a set of principles for allowing these common business risks to qualify for hedge accounting under the proposed U.S. GAAP hedge accounting framework or sharing our perspectives on the issues facing preparers in these areas and their impact on financial reporting.

Probable, forecasted business combinations consummated in a foreign currency

In many cases a reporting enterprise may acquire, through a purchase business combination, a foreign entity in which the purchase price is denominated in a foreign currency. Under U.S. GAAP, the acquirer in a purchase business combination is not permitted to designate a probable, forecasted acquisition in which the purchase price is denominated in a foreign currency as an eligible hedged item in a cash flow hedge on the basis that applying cash flow hedge accounting is inconsistent with the notion of a business combination. While this transaction poses a valid economic risk to the acquirer prior to the final closing of a business combination, the inability to qualify for hedge accounting often requires the acquiring entity to decide between not hedging at all (a less than optimal economic choice) or hedging but explaining the earnings volatility associated with the nondesignated hedging instrument. We note that IAS 39 has recognized this issue and permits the acquiring enterprise to hedge a probable, forecasted business combination in which the purchase price is denominated in a foreign currency. As this form of cross-border business combination has become more prevalent (especially in industries which experience global consolidation in certain economic cycles) and in an effort to converge IFRS with U.S. GAAP, we ask the FASB to reconsider its prior decisions under SFAS 133 (paragraph 473 of the Basis for Conclusions) and allow companies to hedge the foreign currency risk associated with a probable forecasted business combination. This is one area for which we believe convergence could easily be achieved without requiring a change to the underpinning principles of ASC Topic 815.

Hedging probable, forecasted net income of a consolidated foreign subsidiary

We recommend that the FASB reconsider its prohibition on designating probable forecasted net income of a foreign subsidiary as a hedged item in a cash flow hedge of foreign exchange risk. In an era of increased globalization, a greater number of multinational companies generate a significant portion of their earnings from consolidated foreign operating subsidiaries which creates a multitude of challenges including the forecasting of consolidated earnings exposed to currency fluctuations. As many companies manage their revenues, expenses, and net income in the reporting currency (or the parent company's functional currency), prudent risk management strategies are put in place to neutralize the impact of foreign exchange. However, the prohibition for designating net income of a consolidated, foreign subsidiary as an eligible hedged item in a cash flow hedge under U.S. GAAP has created challenges for companies that desire to reduce economic risk but do not wish to recognize the earnings volatility (and income statement mismatch) associated with an undesignated hedging instrument.

We therefore ask the FASB to reconsider the restrictions on hedging the foreign exchange risk of a consolidated foreign subsidiary's net income in light of the increased globalization and the hesitancy of companies to enter into the quantum of derivatives which would be needed to hedge these risks. A change in this area would put multinational companies with foreign subsidiaries that have disparate

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functional currencies relative to the parent and companies whose foreign subsidiaries have the same functional currency as the parent on a similar accounting footing (as the consolidated financial statements of the parent companies in either of the aforementioned cases would reflect congruent accounting for the same economic risk). We acknowledge that the current and proposed hedge accounting models do not permit an entity to designate the hedged item in a qualifying cash flow hedge as a net position comprising transactions with different risk characteristics (e.g., revenues and expenses) which may raise concerns that any proposal to allow the net income of a consolidated foreign subsidiary to qualify as the hedged item conflicts with the core hedge accounting principles. In order to alleviate these concerns, the FASB could permit the parent company to hedge a percentage of their consolidated foreign subsidiaries' revenues or expenses that equates to the expected net income of such subsidiaries. This approach would allow the hedge transaction to be defined in a way that complies with the hedge accounting principles and, at the same time, achieve the intended economic objectives of the hedge.