Federal Deposit Insurance Corporation Board of Governors of the Federal Reserve System National Credit Union Administration Office of the Comptroller of the Currency Office of Thrift Supervision

June 3, 2011

Ms. Susan M. Cosper Technical Director Financial Accounting Standards Board 401 Merritt 7 Post Office Box 5116 Norwalk, Connecticut 06856-5116

RE: File Reference No. 2011-175 – Selected Issues about Hedge Accounting (Including IASB Exposure Draft, Hedge Accounting)

Dear Ms. Cosper:

The staffs of the five federal regulatory agencies responsible for supervising the safety and soundness of U.S. financial institutions (the agencies) appreciate the opportunity to comment on the Discussion Paper, *Selected Issues about Hedge Accounting* (the Discussion Paper). As supervisors, we consider sound risk management to be a fundamental aspect of financial intermediation and take particular interest in accounting standards that promote transparent depiction of hedging activities in institutions' financial reports. We trust our observations will be of use to the Financial Accounting Standards Board (FASB) in its joint deliberations with the International Accounting Standards Board (IASB) (together, the Boards) on their two separate proposals on hedge accounting.

In the agencies' September 30, 2010 letter responding to the FASB's proposed Accounting Standards Update (ASU), Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging, we expressed support for moving from the "highly effective" to a "reasonably effective" threshold for applying hedge accounting and allowing more qualitative factors to be considered in assessing hedge effectiveness as it relates to hedge accounting. We also encouraged the FASB to reduce avoidable complexity in existing standards while improving financial reporting and believe many of the changes the FASB proposed in the ASU could achieve those objectives. Our support of these aspects of the FASB's proposal, however, was conditioned upon reviewing the IASB's parallel work on hedge accounting that culminated in the Exposure Draft included in the Discussion Paper.

 $^{\rm 1}$ $\,$ Letter to Mr. Russell Golden, Technical Director, regarding File Ref. No. 1810-100.

Selected Issues about Hedge Accounting File Reference No. 2011-175 June 3, 2011 Page 2

The IASB's hedge accounting proposal differs substantially from the standards now applicable under U.S. generally accepted accounting principles (GAAP) and the changes to hedge accounting that the FASB proposed. To reiterate our view on convergence expressed in our September 30 letter, we are concerned that, notwithstanding the Boards' commitment to harmonizing accounting standards, the FASB and the IASB issuing fundamentally different proposals creates uncertainty and confusion among preparers and users. Similarly, as commenters are assessing two competing proposals, their message to the standard setters may be conflicting or ambiguous, and therefore difficult to distill and determine what direction should be taken to finalize guidance. We encourage the Boards to work in concert and issue a joint proposal on hedge accounting for global consideration. A more unified process would lift the prospects for timely convergence on high quality accounting standards and would enable interested parties to review and comment on the proposals more efficiently and effectively.

The IASB's stated objective to better align hedge accounting with risk management has conceptual appeal; however, we are concerned that the sum of the proposed changes will diminish the quality of financial reporting. In our opinion, hedge accounting should address accounting anomalies between a hedged item and a hedging derivative and be subject to rigorous qualifying criteria. Risk management is a fluid concept and, by itself, does not provide the rigorous qualifying criteria necessary for hedge accounting purposes. As supervisors we see financial institutions taking many approaches to sound risk management. We also note that an individual institution can change its approach over time. Consequently, a clear framework for hedge accounting in addition to linkage to risk management objectives is necessary to promote comparability among entities in the portrayal of their hedging activities in financial statements.

With respect to the IASB's proposal, the agencies substantially agree with the dissenting alternative view of IASB Board Member Smith as it applies to the hedging of financial instruments. According to Mr. Smith, "the proposals would inappropriately expand the use of hedge accounting, provide a virtually free choice to change the measurement attribute of assets and liabilities...otherwise carried at... amortised cost, are incompatible with and would provide a means of circumventing [existing provisions] and would reduce comparability." We share his opinion and are concerned that the IASB's proposal, if adopted, would expand accounting options available to institutions. Furthermore we are concerned about its potential impact on market discipline as transparency about an institution's use of derivatives could be diminished if the proposal were incorporated into U.S. GAAP. Thus, our conclusion is that we generally favor the FASB's proposal over the IASB's proposal.

² IASB Exposure Draft, *Hedge Accounting*, paragraph AV1.

For example, we would view skeptically an institution offsetting derivative losses with gains recognized on core deposits (that are normally reported at face value) because the effectiveness was "more than accidental" and the entity's risk management objective was to take a particular view on interest rates.

Selected Issues about Hedge Accounting File Reference No. 2011-175 June 3, 2011 Page 3

The agencies have provided specific comments of a technical nature on certain aspects of the IASB's proposal in the annex to this letter. We appreciate your consideration of our comments and we would be pleased to discuss in more detail our views on the Discussion Paper.

Sincerely,

Robert F. Storch Chief Accountant Federal Deposit Insurance Corporation Steven P. Merriett
Assistant Director and
Chief Accountant – Supervision
Board of Governors of
the Federal Reserve System

Melinda Love Director, Office of Examination and Insurance National Credit Union Administration Kathy K. Murphy Chief Accountant Office of the Comptroller of the Currency

Jeffrey J. Geer Chief Accountant Office of Thrift Supervision

Annex

The agencies are pleased to provide the following technical comments and observations on certain aspects of the IASB's hedge accounting proposal:

The Objective of Accounting for Derivatives and Hedging

In the agencies' view, derivatives generally should be measured at fair value through net income. Without hedge accounting, however, reporting derivatives that are used for hedging at fair value and hedged items at amortized cost can have the contrary result of artificially increasing earnings volatility when in fact volatility has been reduced. Thus, hedge accounting primarily should mitigate measurement mismatches, or anomalies, between derivatives and financial instruments reported at amortized cost. There is no need for hedge accounting for economic hedges of derivatives and financial instruments measured at fair value through net income, or for economic hedges of cash instruments where both the hedging instruments and hedged items are reported at amortized cost. Since hedge accounting acts to mitigate accounting anomalies, its use should align with an entity's risk management objectives rather than be principally reliant upon them.

As prudential supervisors, we see a wide range of approaches to risk management among financial institutions. For example, some entities hedge substantially all of their balance sheet, while others may use derivatives to hedge a particular business segment, reporting unit, or group of transactions. Furthermore, an institution may revise its risk management activities to respond to changes in business objectives or economic conditions. Because risk management approaches are disparate, a clear framework for applying hedge accounting (*e.g.*, classification of hedge relationships into fair value and cash flow hedges, clear effectiveness tests, appropriate documentation, and robust disclosure) promotes uniformity among entities in portraying hedging results in financial statements.

The IASB's Proposed Criteria for a Qualifying Hedge Relationship

An accounting principle that bases hedge accounting on an entity's risk management objectives has conceptual appeal; however, risk management is a fluid concept. Therefore, if risk management objectives were to serve as the sole qualifying criterion for hedge accounting, we believe that consistency and comparability in financial reporting would be severely diminished. In this regard, we acknowledge that the IASB's approach includes qualifying criteria in addition to a hedge relationship meeting an entity's risk management objectives.

Certain terms used in the Annex have the following meanings: "Anomalies" encompasses both accounting measurement mismatches and certain cash flow mismatches that qualify as cash flow hedges; "financial instruments" refer to those instruments not measured at fair value through net income that are designated as hedged items; and "amortized cost" refers to all measurement bases other than fair value through net income.

² For example, a fixed-rate prepayable bond investment funded by a fixed-rate callable debt would be considered a natural hedge; if both are reported at amortized cost there is no need for hedge accounting as there is no accounting anomaly.

As one of these additional qualifying criteria, the IASB proposes a hedge effectiveness requirement that is a three-part test: (i) the hedge relationship must produce an unbiased result, (ii) the hedge relationship must minimize expected hedge ineffectiveness, and (iii) hedge offset must be expected to be "other than accidental." These three effectiveness criteria replace the IASB's existing "highly-effective hedge" requirement of an 80 to 125 percent offset. The IASB characterizes this existing criterion with its explicit percentages as an undesirable bright-line requirement.

The three effectiveness criteria in the IASB's proposal can be interpreted as permitting hedge accounting for a hedge relationship in which the hedged item and the hedging derivative have weak negative correlation,⁴ so long as the hedge relationship is not biased and the hedging instrument is the most effective available. While it is true that all hedge ineffectiveness would be reported in net income, we are concerned that there may be few situations where hedge accounting could not be applied under these effectiveness criteria.

Rather than the IASB's three-part test, we favor changing the threshold for hedge effectiveness from "highly effective" to "reasonably effective" and allowing entities to consider qualitative aspects of the hedge relationship when appropriate as the FASB proposed in its ASU on accounting for financial instruments. However, to ensure such an approach is implemented as intended, we would encourage the FASB to provide additional guidance on the types of qualitative judgments that are consistent with a "reasonably effective" threshold. If supplemented as we suggest, we believe that such a threshold would be more readily understood by users and implemented by preparers than the IASB's proposed effectiveness criteria. This may also reduce the incidence of "onesided marks" on prudent hedges that nevertheless fail from time to time to meet the existing "highly effective" threshold. It would also have greater rigor than permitting hedge accounting where there is weak negative correlation (but more than "other than accidental" offset) between the hedging derivative and the hedged item. We also note that the existing "highly effective" and the FASB's proposed "reasonably effective" thresholds correspond to principles in statistics of correlation and dependence and are not an arbitrary bright-line rule.

Removal of Retrospective Testing

Although we support allowing more qualitative factors to be considered in assessing hedge effectiveness, we consider risk management to be an undertaking that is inherently quantitative in nature. Risk exposures and methods for mitigating risk need to be

The IASB describes the first two conditions as the objective of the hedge effectiveness assessment.

⁴ Not restricted to the meaning of "correlation" as used in statistics.

quantifiable.⁵ The feedback an entity gains from monitoring the performance of a hedging program is used to modify positions in order to improve subsequent effectiveness. Because of the existence of this management feedback process, we support maintaining an ongoing evaluation of effectiveness as a part of hedge accounting, if even on the basis of a "change in circumstances" as the FASB proposed in its ASU last year. We note that regardless of the threshold specified for qualifying for hedge accounting, entities would be required to measure ineffectiveness for their hedging relationships.

Recognizing the Effective Portion of All Hedges in Other Comprehensive Income and the Reporting of Hedge Offset

We prefer the current practice of recognizing hedging activities (with the exception of cash flow hedges) in their entirety in net income. We note that when it originally issued its existing hedge accounting guidance in 1998, the FASB regarded cash flow hedging of anticipated transactions as an exception. Along those lines, we do not believe the exception for recognizing effective hedges in other comprehensive income (OCI) should become the norm. We acknowledge that the two recognition approaches result in the same bottom line for fair value hedges because net income is affected only by hedge ineffectiveness. Nevertheless, we believe that requiring entities to fully recognize the results of these hedges in net income would tend to more sharply focus its management's attention on the extent to which offset is being achieved in its hedging activities than if the effective portion of these hedges were classified in OCI. As a consequence, we believe the entity would more carefully monitor and control its use of derivatives.

We acknowledge that the Boards have received comments from users that the current treatment of hedged item basis adjustments is opaque. For fair value hedges, the IASB has proposed that an entity present fair value changes attributable to the hedged risk as separate line items on the balance sheet. We believe that fair value changes presented in this fashion would not be inherently more transparent than existing practice and could be misleading in certain circumstances. Hedged item basis adjustments can be better explained through improved disclosure rather than separately presenting the information on an entity's balance sheet.

Risk Selection and the Hedging of Credit Risk

We agree with the IASB's observation that it is often difficult to qualify hedges that use credit derivatives under existing hedge accounting criteria. We also agree that it is not currently desirable (if convergence is to be achieved according to the Boards' timetable) to develop alternatives to the general model for derivatives and hedge accounting. We note, however, that under existing GAAP an entity that either does not elect hedge

Our expectation regarding risk management is incorporated in the agencies' Uniform Financial Institution Rating System. Under this system, each financial institution is assigned a composite rating based on an evaluation of six essential components of an institution's financial condition and operations. When evaluating the management component, examiners consider the capability of an institution's board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of the institution's activities.

accounting or does not qualify for it would recognize gains in net income on a purchased credit derivative as credit deterioration makes the protection more valuable, which would tend to occur earlier than credit loss on the protected asset is recognized in net income. We are concerned that the IASB is taking (or may be interpreted as taking) the position that an entity's hedge of credit risk cannot qualify for hedge accounting. If hedge accounting rules otherwise permit risk selection when a risk component is separately identifiable and reliably measurable and the rules are stringent in terms of hedge effectiveness, hedge accounting should be permitted for credit derivatives, just as it would be for any derivative, when these conditions have been met.

Instruments Qualifying as Hedging Instruments

As previously indicated, we believe hedge accounting should address measurement and timing mismatches arising between derivatives and items measured at amortized cost. Few non-derivative financial instruments are currently required to be measured at fair value through net income, without regard to the entity's intent regarding those instruments. Under U.S. GAAP, the fair value option is available for those financial instruments not required to be measured at fair value through net income, which can address certain accounting anomalies without resorting to hedge accounting. Although some instances of hedging with financial instruments other than derivatives are now permitted under U.S. GAAP, further expansion of this activity, which has been proposed by the IASB, should not be considered without limits being placed on the financial instruments that may be designated as hedging instruments. Otherwise, the combination of the proposed "other than accidental" offset and non-derivatives qualifying as hedging instruments would create another elective measurement category for a broad range of financial instruments (and for nonfinancial assets and liabilities designated as fair value hedged items): fair value through OCI.

Designating Layers as Hedged Items

We note that the concept of "layer designation" under existing U.S. GAAP often relates to cash flow hedges of anticipated transactions, which do not present the same degree of price risk as legally-binding firm commitments. The latter typically are designated as the hedged item in fair value hedges. There may be conceptual merit to layer designation for hedged items consisting of large numbers of essentially fungible financial instruments. However, we are concerned that a broader application of layer designation for hedged items in fair value hedges could allow combining items having different risk characteristics. If layer designation is too expansive, it could reduce the discipline that is now required to identify and measure risk exposures for purposes of qualifying for hedge accounting. There may be the potential to "cherry pick" among hedged layers to minimize reported ineffectiveness. We encourage the FASB and the IASB to consider more research and field testing to assess the practical consequences of this aspect of the proposal.

Hedges of Groups of Items

Under U.S. GAAP, entities can designate only a single asset or liability or a portfolio of similar assets or liabilities (or a specific portion thereof) as a hedged item in a hedge relationship. An economic hedge of a group of dissimilar assets or liabilities, or a residual or net position of assets and liabilities, does not qualify for hedge accounting. This limitation helps ensure that basis adjustments from hedge offset can be allocated in a rational and systematic way for such purposes as determining gain or loss when a hedged item is sold or settled. This allocation requirement helps to ensure that hedging losses are not inappropriately deferred. Accordingly, we are concerned that, in a dissimilar group or net position, some of the items being hedged may have positive rather than negative correlation with the hedging derivative. This makes it difficult, if not impossible, to allocate offset if the components of the hedged item respond differently to a change in the risk being hedged. We are concerned that the IASB's proposal would result in a loss of accounting rigor if hedges of dissimilar items or net positions of assets and liabilities are permitted.

We do not support the IASB's proposal to allow combining derivatives with financial instruments into an aggregated exposure, oftentimes referred to as synthetic instrument accounting, for purposes of creating an eligible hedged item and applying hedge accounting if the qualifying criteria are met. We do not regard the synthetic instrument to be identical to the instrument it is intended to replicate because the concept disregards sources of ineffectiveness that are potentially significant. Lastly, we believe allowing synthetic accounting would add complexity to the accounting standards, which the Boards are seeking to reduce.