Mr. Russel G. Golden Director of Technical Application & Implementation Activities Financial Accounting Standards Board



Via Email

File Reference No. 1590-100 Exposure Draft: LETTER OF COMMENT NO. 5 5

Accounting for Hedging Activities, an amendment of FASB Statement No. 133

August 15, 2008

We appreciate the opportunity to comment on the FASB's Exposure Draft Accounting for Hedging Activities, an amendment of FASB Statement No. 133 ("the Exposure Draft"). We have numerous derivative counterparty clients that seek to apply hedge accounting for various hedging relationships. We believe that the guidance in the Exposure Draft could, from a practical perspective, make it more difficult to apply hedge accounting rather than simplifying it as the Board intends.

We appreciate the Board's intention to simplify the application of hedge accounting under Statement 133 and believe that some of the proposed changes, such as those regarding assessing hedge effectiveness, represent a positive step toward simplification. However, overall, we do not believe that the Exposure Draft will simplify the application of hedge accounting. In fact, we believe that the Exposure Draft merely changes the areas of complexity in most hedging relationships, will render hedge accounting more complex in some cases, and will diminish (rather than enhance) the transparency of financial statements.

We are also very troubled that the FASB is contemplating such a radical shift in the accounting for hedging activities in a manner that does nothing to further convergence with International Financial Reporting Standards, at a time when such convergence is its stated goal and when the IASB has just started its own project to review the accounting for hedging activities. The costs to implement the changes proposed in the Exposure Draft, both in terms of systems development and accounting and treasury staff time, will be considerable and may well turn out to be in place for only a short duration.

Finally, the changes themselves will not improve financial reporting and seem likely to confuse both users and preparers alike. Under the model proposed in the Exposure Draft, corporate clients that swap their debt would record gains and losses as their spreads change simply because they seek to reduce the interest rate duration of their debt by swapping to floating. We do not believe that most investors will understand this (despite the comments from ITAC) and also do not believe that it makes sense. In addition, the changes to the mechanics of cash flow hedge accounting will result in phantom gains and losses being recognized – the first time we can recall gains and losses being recognized in earnings for transactions that were not executed. Finally, an apparent technical change

to Foreign Exchange hedging will have significant implications without the reasoning being explained in the Exposure Draft, rendering comment on the change difficult. Given all of these observations, we do not believe that the FASB should proceed with its proposed amendment of Statement 133.

Detailed comments on the Exposure Draft and on the questions that the FASB requested specific feedback on are set forth on the following pages. Please contact either myself at 212-902-7052 or Nora Joyce at 212-357-8391 if we can be of further assistance or if you have questions about our comments.

Sincerely,

Timothy J. Bridges Managing Director

Cc Nora Joyce, Goldman Sachs & Co. Matthew Schroeder, Goldman, Sachs & Co. 1. Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?

We believe that the Exposure Draft will impair the usefulness of financial statements by eliminating the ability to designate individual risks.

The basic model in the Exposure Draft is a fair value hedging model (as opposed to the risk bifurcation model in Statement 133 currently). With the exception of hedges executed concurrent with the issuance of the debt, interest rate risk would no longer be hedgeable as a separate risk.

- For example, in a "late hedge" swap to floating of a fixed rate bond, the bond would now be marked to market (i.e. for both rates and credit spread changes).
- Similarly, in a pre-issuance hedge, ineffectiveness would be measured by comparing the hedge (rate lock or forward starting swap) to a hypothetical derivative that would hedge the all-in issuance level.

We do not see how this improves either the reliability or usefulness of financial statements.

Reliability

The challenges corporate clients have faced in trying to implement Statement 157 will continue under the fair value hedging model proposed in the Exposure Draft. The majority of fixed rate bonds are not actively traded — they may be held by retail accounts, or simply infrequently traded. Corporate clients that swap fixed rate debt to floating will nevertheless be required to try and come up with a fair value that will drive the earnings impact of the hedge. At present, while the mechanics are not always simple, corporate clients can calculate the change in value due to the benchmark interest rate by reference to a readily observable measuring stick (the swap rate). In contrast, under the proposed model, they will have to estimate where the hedged debt would be priced even though it may not have traded in many months, and corporate clients may not have credit curves that allow them to make a reasonable estimation of fair value.

Usefulness

Under the proposed amendment to Statement 133, changes in an issuer's credit spreads will now be recognized in earnings simply because the company elects to swap the debt to floating (i.e. to reduce the duration of its liabilities). The net effect for such hedges is that earnings will now be exposed to volatility arising from changes in the issuer's credit spread as well as any ineffectiveness from long haul hedge accounting. This is not only troubling as the credit spread risk is largely unhedgeable but also will prove confusing to investors as the only reason for picking

up the change in credit spreads is because the company executed a hedge of its debt. Further adding to the complexity, companies will now need to obtain prices for hedged debt that may not be traded with any frequency.

Cash flow hedge accounting will also become much more complex as a result of the proposed changes in the Exposure Draft. In hedging a forecasted debt issuance, the issuer will need to determine where it thinks it could issue as of the date of the hedge in order to determine the terms of the hypothetical derivative. Besides the readily observable benchmark rate, the company will need to determine its credit spread for the appropriate maturity. Some companies may be able to do this as they have observable credit curves, but many companies will not be able to objectively determine where their current spreads are as they do not have frequently traded debt and may not have extant debt that approximates the debt being issued. Finally, an issuer will then have to make a guess about what new issue concession (spread to where its current bonds of a like maturity are trading) investors would require. This can only really be determined when the actual deal is marketed, and new issue concessions have been extremely volatile in recent months. One of the most complex and frustrating areas that our clients have found is trying to construct hypothetical derivatives for items that are not traded (such as when trying to hedge commodity exposure). The proposed changes will extend this complexity to interest rate hedging. In contrast, under the current model, the hypothetical derivative is easily determinable as the benchmark rate is readily observable.

2. Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?

For the reasons set out above, we believe that the Board should continue to permit an entity to designate those individual risks as a hedged risk, and indeed should expand hedgeable risks to individual tradeable commodities.

3. Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships?

As we have discussed above, we believe that there are significant operational constraints and difficulties in calculating hedge ineffectiveness for both fair value and cash flow hedges under the model proposed in the Exposure Draft.

4. Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?

We believe that the proposed elimination of the shortcut method and critical terms matching will impair the usefulness of financial statements and make Statement 133 less operational. We would support elimination of the shortcut guidance if the concept of critical terms matching were extended to interest rate swaps hedging extant debt. We believe that an enunciation of a principal that if the significant economic terms of an exposure (for example, terms in a bond to which an investor would ascribe meaningful value) are matched, then an assumption of no ineffectiveness is appropriate. We believe that the end result (synthetically creating a floating rate liability) is simpler while being at least as useful and representationally faithful of the actions of the enterprise than an artificial calculation of ineffectiveness arising from either risks that the enterprise was not hedging or from the mechanics of long haul hedge accounting for interest rate risk.

5. Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

We are generally supportive of the proposed modification of the effectiveness threshold from highly effective to reasonably effective and from a quantitative to a qualitative threshold. We have some concerns that there could be differing interpretations of reasonably effective by regulators and auditors, but believe that if all parties are willing to allow for reasonable judgment as opposed to a bright line, then such a threshold will simplify the application of hedge accounting. We believe that a simple illustration of the concept would help to illustrate what the Board intends.

For example, Company A issues a 10 year bond with a coupon of 6%. It enters into a pay fixed, receive 3 month Libor swap whose duration reasonably approximates that of the bond. It is therefore able to conclude that the swap is a reasonably effective hedge. This is a useful illustration as otherwise we fear companies will have to perform a quantitative analysis of credit spread volatility versus interest rate volatility in order to justify the conclusion that the hedge is reasonably effective.

6. Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period?

Companies will still need to calculate ineffectiveness or (if critical terms match survives and is applied) to affirm each period that it has still matched the critical terms. The processes for these should facilitate identifying when a hedge relationship may no longer be reasonably effective.

7. Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued?

It would seem that this requirement coupled with a less onerous "reasonably effective" standard would facilitate more hedge relationships qualifying. It is difficult to judge how it would impact the number that would subsequently fail to qualify for hedge accounting.

8. Do you agree with the Board's decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term?

We believe that the Board's decision to require that hedge accounting be discontinued if a hedge becomes ineffective is consistent with the principle that hedge accounting should only be applied if a hedge is reasonably effective, and it seems that some qualitative monitoring of this is reasonable.

9. Other Items

Prohibition on De-designation (Paragraph 25)

We do not agree with the prohibition on ceasing hedge accounting by de-designation of a hedging relationship. We are not aware of any abuse (for example, in terms of changing the timing of income statement recognition) that can be caused by the ability to de-designate a derivative. Conversely, by imposing such a restriction, companies would at worst lose the flexibility to actively adapt to a changing risk profile and at best would

face added complexity in their designation and hedge monitoring. As the proposed changes to paragraph 167 illustrate, a simple designation would result in a hedge having to be split into component pieces creating multiple hedging relationships on Day 1 instead of a single relationship.

Change to the Mechanics of Cash Flow Hedge Accounting

Currently only over-hedges (excess ineffectiveness) in cash flow hedges impact earnings. We believe that this makes sense as it reflects the actual gains/losses arising from the hedging derivative.

Under the proposed changes in the Exposure Draft, all cash flow ineffectiveness will impact earnings. Consider the two squares highlighted in yellow in the following table.

Hedge Result	Perfect Hedge Result	P/L Impact under Current Guidance	P/L Impact under Exposure Draft Model
\$8 gain	\$10 gain	\$0 (\$8 gain in OCI)	\$2 loss (\$10 gain in OCI)
\$12 gain	\$10 gain	\$2 gain (\$10 gain in OCI)	\$2 gain (\$10 gain in OCI)
\$8 loss	\$10 loss	\$0 (\$8 loss in OCI)	\$2 gain (\$10 loss in OCI)
\$12 loss	\$10 loss	\$2 loss (\$10 loss in OCI)	\$2 loss (\$10 loss in OCI)

In the first highlighted square, the company executed a hedge that generated a gain of \$8. The hypothetical derivative indicates that the perfect hedge would have generated a gain of \$10. The proposed changes to paragraph 30b would result in a loss of \$2 being recognized in earnings even though the hedge generated a gain. This loss represents the change in the present value of future cash flows (for example forecasted sales) not offset by the hedge. In the second highlighted square, we see that the company would record \$2 of income when it actually lost \$8. Thus we have income statement recognition of the effect of changes in hedged forecasted cash flows, as opposed to the recording in OCI of the effect of the hedge. To put it another way, the balance in OCI will now reflect the results of a transaction the company did not do (the perfect hedge) rather than the results of a transaction that it did execute. We find this perplexing and believe that it will cause confusion for investors. ("The hedge lost money but not as much as it should have so you booked a gain?").

Change to Paragraph 40 regarding Foreign Currency Hedging

We and many of our clients are confused by what appears to be a technical change to Paragraph 40 of Statement 133 regarding hedging the FX risk of forecasted intercompany transactions. We do not understand what the change means nor why it is being made. It appears that hedges of intercompany royalties will not be able to be designated as hedges in the consolidated financial statements on the grounds that the hedged transaction does

not present a potential earnings effect that survives consolidation. However, no forecasted transaction affects earnings until the transaction occurs. The wording in the Exposure Draft would appear to eliminate the ability to apply hedge accounting in the consolidated financial statements of forecasted intercompany sales/purchases as such sales/purchases also eliminate. If this were to be the effect of the proposed wording change, it would have a drastic effect on the ability of companies following US GAAP to hedge their foreign exchange exposures. Both intercompany sales and intercompany royalties do create exposure in the consolidated financial statements. Consider the example of a US Dollar functional parent that imports a product in Euros from its Euro functional subsidiary. It then sells the product in US Dollars. The forecasted intercompany purchase presents an FX exposure to the parent. Similarly, on a consolidated basis, the company has forecasted Euro costs for forecasted US Dollar sales. (This foreign exchange exposure can be clearly seen if we substitute the cost of goods in the consolidated financial statements with purchases of the goods in Euros from a third party). Given that foreign exchange hedging in Statement 133 is predicated on the functional currency model of Statement 52, we do not believe that such a change should be made without further consideration and public discussion.