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September 20, 2007

LETTER OF COMMENT NO.

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

Re: Proposed Statement 133 Implementation Issue No. E23, Hedging-General: Issues Involving the Application of the Shortcut Method under Paragraph 68

Dear Mr. Golden:

We appreciate the opportunity to comment on the abovementioned Proposed Statement 133 Implementation Issue ("Proposed Issue E23") and applaud the Board addressing a topic that has caused so much consternation to its constituency.

We generally agree with the "Alternative Views" presented by the three Board members in the minority. Accordingly, we support the Board's conclusions regarding the permissibility and/or nonpermissibility of the use of the shortcut method for topics listed below. In almost all of these cases, we have had to answer shortcut questions on these topics over recent years, and our answers have been generally consistent with the Board's proposed conclusions.

- Settlement of Hedged Item Occurs Subsequent to Trade Date
- Hedged Item is Subject to Principal Pay-Downs Prior to Maturity
- Application of Paragraph 68(b) When the Transaction Price of Interest Rate Swap is Zero
- Inception at Recognition of Hedged Item—Effect of the Normal Market Convention of Rounding the Coupon Rate
- When the Hedged Item Is a Zero-Coupon Financial Instrument

However, we do not support the majority's conclusion that a condition of the shortcut method is that the fair value of the hedged item has to equal its principal amount, thus disqualifying the vast majority of hedge relationships under which entities applied the shortcut method. Statement 133 does not have this requirement, nor was there ever any indication in any public meeting during the Board deliberations for Statement 133 or the Derivatives Implementation Group deliberations after the issuance of Statement 133, that this requirement was implied or inferred.

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Accordingly, thousands of shortcut hedges have been executed in this decade under the correct assumption (in our view) that this was not a required condition of the shortcut method.

The Alternative View presents compelling evidence proving that Statement 133 does not include this requirement, citing the absence of the condition from paragraph 68, Statement 133 Implementation Issue E10, and Statement 133 Implementation Issue E15, and noting the prominent footnote in paragraph 115 that states that the trade date of the interest rate swap and the borrowing date of the fixed-rate debt *need not match* for the assumption of no ineffectiveness to be appropriate.

Not mentioned by the Alternative View but also relevant is the last section of the Response to Question 2 of Statement 133 Implementation Issue J9 ("Use of the Shortcut Method in the Transition Adjustment and upon Initial Adoption") in which the FASB staff explains how the shortcut method can be applied at transition to an existing debt instrument that had not previously been hedged, as long as the swap fair value was zero at the date of initial adoption of Statement 133. This Response did not require the fair value of the hedged debt instrument to equal its principal amount for this newly executed hedge.

The Board members that issued Statement 133 never intended to prohibit the use of the shortcut method for so-called "late hedging," which is why there has been no diversity in practice on this point as shortcut has been universally applied in late hedging scenarios. However, we certainly acknowledge that the majority on the current Board may have concerns about late hedging and regret the decisions that paved the way for the shortcut method to be utilized and understandably, wish to amend the standard. We hope to alleviate some of those concerns in the remainder of this letter, but first we have some overall observations on the shortcut method and this project.

What is the Underlying Precept of the Shortcut Method?

Our understanding of the original objective of this project was that the Board believed the shortcut method should continue to be available, and this project should clarify when it can and cannot be used, without amending Statement 133. We are not certain that Proposed Issue E23 accomplishes that objective. One reason it appears to fail is that the Board members disagree on the underlying precept: is the objective of the shortcut method to merely "simplify the bookkeeping requirements for a narrow set of highly effective, extremely common transactions" (to quote the Alternative View), or is the objective to permit only interest rate swap hedge relationships with immaterial amounts of ineffectiveness to ever qualify for the shortcut method? We believe that both objectives can be met without prohibiting the use of the shortcut method for late hedging.



Paragraph 68(e) and Paragraph 70

The confusion over the underlying precept of the shortcut method is evident in the decision to preserve paragraph 68(e), which requires that the terms of the swap and hedged item must both be "typical and not invalidate the assumption of no ineffectiveness." We question whether there is a consistently understood interpretation of the word "typical" as used in paragraph 68(e). However, and much more importantly, confusion will be perpetuated unless the Board acknowledges the continued (and necessary) existence of paragraph 70.

Paragraph 70 recognizes that comparable credit risk at inception is not a condition for assuming no ineffectiveness. Because credit risk between two swap counterparties, a two-way risk, fundamentally cannot be comparable to the one-way credit risk between a debtor and a creditor, the all-in fixed rate of a swap (with a fair value of zero) will never equal the all-in fixed rate of the hedged debt instrument. This unavoidable fact explains why any sort of "long-haul" application of measuring hedge ineffectiveness to a shortcut-eligible fair value hedge will never result in an answer of zero ineffectiveness. Such achievement is impossible, and paragraph 70 got it right in the first place by not making "comparable credit risk" a requirement.

But how is paragraph 70 supposed to survive if paragraph 68(e)(2) also survives, even after this reconsideration of the shortcut method? How will anyone be able to say that **none** of the terms of the interest-bearing financial instrument invalidates the assumption of no ineffectiveness?

We do not support the continued inclusion of paragraph 68(e) in the shortcut method because we believe it is inherently incompatible (for fair value hedges at least) with the rest of the paragraph.

Why the Board Should Not Be Uncomfortable with Permitting Shortcut for "Late Hedges"

The accounting theory concept behind a fair value hedge clashes with the risk management intent behind most constituents' needs. Treasurers conceptualize the fair value hedge as "swapping the coupon" on a debt instrument and their intuition is to seek the swap that does so "perfectly". Their orientation is to adjust interest expense or interest income to a market rate.

But the Statement 133 fair value hedge model for interest rate risk is really based on a different concept: the fair value hedge provides an offset to a possible early extinguishment gain or loss if the debt is not held until maturity but extinguished for fair value. This concept—that of a possible early extinguishment—is how the fair value hedge of interest rate risk satisfies paragraph 21(b): "the hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings" (emphasis added). We believe that because constituents so rarely conceptualize a fair value hedge of fixed rate debt in this way (the risk of early retirement of the debt asset or liability), the concept of "ineffectiveness" when the shortcut

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method is not applied becomes entangled with the hedger's desire to amortize fair value hedge carrying value adjustments such that the instrument will be carried at par at maturity and settled for no gain or loss. We believe it is improper to conceive of the amortization of a carrying value adjustment to "cause" ineffectiveness. Such amortization to par at maturity is not a requirement of Statement 133 as long as the debt instrument remains hedged, and we believe it is easier to analyze this issue if one assumes no amortization and no holding of the debt instrument until maturity. In that light, we offer the analysis that follows.

We believe that a "late hedge" addresses a different fair value risk than an "at-inception" hedge that begins at the initial recognition of a debt instrument, and it is entirely appropriate that two different swaps be used for the two different relationships. We do not believe that the original FASB decision to permit late hedging was incorrect.

A shortcut hedge by definition is a hedge of "interest rate risk," and "interest rate risk" is defined in Statement 138 as meaning the risk presented by the change in the relevant benchmark *swap* rate (emphasis added).

Consider a fixed-rate debt instrument (a liability) with a five-year life that originates on January 1, 2008 and matures on January 1, 2013. An at-inception hedge which Proposed Issue E23 would allow to qualify for the shortcut method would consist specifically of a hedge of the fair value of that debt instrument attributable to changes in the five-year LIBOR swap rate for the period January 1, 2008 to January 1, 2013. Suppose that five-year LIBOR swap rate is 6.00% on January 1, 2008. The hedging instrument would consist of a receive fixed 6.00% and pay floating-plus/minus-appropriate-credit-spread swap that equates to a fair value of zero at January 1, 2008.

Now consider a late hedge of that instrument that begins on January 1, 2009. A late hedge, which Proposed Issue E23 would not allow to qualify for the shortcut method, would consist specifically of a hedge of the fair value of that debt instrument attributable to changes in the four-year LIBOR swap rate for the period January 1, 2009 to January 1, 2013. Suppose that the four-year LIBOR swap rate is 7.00% on January 1, 2009. The hedging instrument that could accomplish that objective most effectively is a receive fixed 7.00% / pay floating-plus/minus appropriate credit spread swap that equates to a fair value of zero at January 1, 2009. The most appropriate and effective hedging instrument is *not* the same hedging instrument described in the preceding paragraph, which would now be one year old and would have a fair value either greater than or less than zero.

We inferred from the Basis for Conclusions for Proposed Issue E23 that a key reason the majority of the Board is inclined to prohibit shortcut for late hedges is that they believe the most economically effective hedging instrument for the late hedge is the five-year swap that no longer



has a fair value of zero at the beginning of its second year, and the Board does not want to endorse a swap with embedded financing (e.g., a fair value other than zero) as shortcut eligible. The Basis for Conclusions states:

"...the non-par fair value of the debt means that, even after considering the effect of the credit spread differential that paragraph 70 contemplates, there is a higher or lower yield on the debt than on par debt. The value of this coupon differential, which is not merely compensating for credit risk, is, like any other cash flows to be received in the future, subject to change in value as benchmark rates change. Those changes, which would not be expected to be offset by changes in a zero-fair-value swap, will create ineffectiveness, causing the relationship to fail the requirements of paragraph 68(e)."

We believe the concern in this passage is misplaced, because the "benchmark rate" being hedged in the late hedge is a different benchmark rate than in the at-inception hedge. A benchmark rate is not a generic concept like "LIBOR," but a particular LIBOR swap rate¹ (e.g., the fixed rate that fits a LIBOR curve for the hedge period). The "late hedge" using a different zero-fair-value swap than the at-inception hedge did, will be equally effective at hedging its unique benchmark rate risk as the "at-inception" hedge did.

The "late hedge" (by definition of "benchmark risk" in Statement 138) hedges a different risk than the "at-inception" hedge and should not use the same hedging instrument. The late hedge in the above example hedges the fair value of the fixed-rate debt instrument attributable to changes in the four-year LIBOR swap rate that begins on January 1, 2009 at 7.00% and continues to change thereafter until January 1, 2013. The at-inception hedge at January 1, 2009 is still hedging changes in the five-year LIBOR swap rate that began at 6.00% one year earlier and is now at a different rate (likely close to 7.00% but unlikely to be exactly 7.00%). The two hedges hedge different benchmark interest risks and therefore should use different swaps. Neither swap is inherently more effective than the other at hedging its unique risk.

Paragraph 369 of Statement 133 is consistent with this observation:

"...the gain or loss on the hedged item that is accelerated and recognized in earnings is the portion of the gain or loss that is attributable to the risk being hedged. Although the Board considered several approaches to measuring the gain or loss attributable to the risk being hedged, it decided not to provide detailed guidance on how that gain or loss should be measured. The Board believes that the appropriate measurement of the gain or loss on a hedged item may depend on how an entity manages the hedged risk. Consistent with its decision to require an entity to define at inception how it will assess hedge effectiveness, the Board decided that an entity also should define at inception how it will measure the

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¹ Paragraph 16 of Statement 138.



gain or loss on a hedged item attributable to the risk being hedged. The measurement of that gain or loss should be consistent with the entity's approach to managing risk, assessing hedge effectiveness, and determining hedge ineffectiveness. It follows that the gain or loss on the hedged item attributable to the risk being hedged can be based on the loss or gain on the derivative, adjusted in certain ways that will be identified during the assessment of hedge effectiveness."

So why is there confusion? Because the late hedger's decision *not* to use a fair value hedge of interest rate risk from the inception date of the fixed-rate debt instrument inherently implies that if that debt is extinguished prior to maturity, the *entirety* of the extinguishment gain or loss other than attributable to credit risk will not have been hedged. The changes in fair value of the debt instrument in our example from its inception through its extinguishment are attributable to three sources:

- 1. Changes in the debtor's credit spread (excluded from hedges of interest rate risk)
- 2. Changes in the relevant benchmark swap rate from inception to the hedge designation date (company elects *not* to hedge this risk in this example)
- 3. Changes in the relevant benchmark swap rate from hedge designation date until extinguishment (hedged in this example)

The zero fair value swap used in a late hedge is not designed to be (and will not be) highly effective at hedging (1) or (2), but it will be highly effective at hedging (3). The extinguishment gain or loss that is attributable to sources (1) and (2) will not be offset by a comparable loss or gain on the late hedge swap, but the extinguishment gain or loss attributable to (3) will be.

Suppose the debt is extinguished one year early on January 1, 2012 for a gain or loss. (For conceptual ease, suppose the hedger elected not to amortize any fair value hedge carrying value adjustments, as Statement 133 does not require it.) The portion of the total extinguishment gain or loss attributable to the first year's movement in the 5-year LIBOR swap rate from January 1, 2008 to January 1, 2009 was not hedged, so the swap instrument provides no offset for that risk. It does however provide offset for the portion of the total extinguishment gain or loss attributable to the movement in the 4-year swap rate from January 1, 2009 to January 1, 2012, the extinguishment date. In our view, there is no more hedge ineffectiveness in this relationship than there is in the "at-inception" benchmark interest rate risk hedge.

Another reason for the confusion is that practitioners and auditors have not been forced to analyze these issues until very recently, as fair value hedges of interest rate risk were almost all universally applying the shortcut method. In fact, the argument we have outlined above to advocate continued use of shortcut for late hedges was only recently conceived by us, and we have not shared it with the staff during the months leading up to this exposure draft. Confusion



over how to apply a "long-haul" approach to a hedge of interest rate risk cannot be overstated. We understand the Board members became acquainted with these struggles during a June 2006 Education Session. We observe that should the Board finalize a prohibition of use of the shortcut method for "late hedges," pressure on the Board will mount for clarity on how to apply "long-haul" concepts, and particularly, how to amortize carrying value adjustments to the hedged item in a manner that will not make the income statement look nonsensical.

Prohibition for Late Hedging Would Essentially End Shortcut Method

Use of the shortcut method for cash flow hedges is already rare, because most variable-rate debt instruments are prepayable at par, which is not equivalent to fair value². Most shortcut applications are fair value hedges of fixed-rate debt in late hedging scenarios, which Proposed Issue E23 would amend Statement 133 to prohibit.

Would it really be worth preserving the shortcut method if only a few constituents could ever use The Board's proposed conclusion on "late hedging" would leave the shortcut method available only to investors participating in initial underwritings and to issuers only upon initial debt issuance. We question how large a population of constituents would still benefit, or even desire to benefit, from the shortcut method if it were available only at one specific point in time. Most issuers who desire the economics of floating-rate debt would simply issue floating-rate They would not likely issue fixed-rate debt and simultaneously enter a fair value hedge with a pay floating/receive fixed interest rate swap at inception. The desire to swap fixed-rate debt to floating is typically one that emerges later in the life of the debt instrument as market conditions change and/or the entity desires to alter its "mix" of fixed debt vs. floating debt to reposition its exposure based on its view of interest rates. Secondary market investors other than original, at-inception lenders, would never be able to use the shortcut method.

We would be pleased to discuss our comments with the Board members or the FASB Staff at you convenience.

Sincerely,

Ernst + Young LLP

² Most variable-rate debt fits Illustrative Debt Instrument #5 of Statement 133 Implementation Issue E6, "The Shortcut Method and the Provisions That Permit the Debtor or Creditor to Require Prepayment." The shortcut method cannot be applied to instruments like Illustration #5.