

VIA ELECTRONIC MAIL (director@fasb.org)

September 30, 2010

Mr. Russell Golden
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 1810-100, Proposed Accounting Standards Update:
*Accounting for Financial Instruments and Revisions to the Accounting for Derivative
Instruments and Hedging Activities***

Dear Mr. Golden:

Chatham Financial (“Chatham”) is pleased to comment on the Financial Accounting Standards Board’s (“FASB”) Exposure Draft of Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the “proposed ASU”). Chatham serves as a hedging advisor to over 1,000 companies in many different industries. Chatham assists its clients with derivatives and hedging activities on a daily basis for thousands of derivative transactions, including providing assistance with hedge strategy development, transaction execution, hedge designation memos, effectiveness testing, derivative valuations, journal entries, and footnote disclosures, which provides us with a unique opportunity to observe and consult on a wide array of hedging strategies utilized in practice. Given our role, we believe that we are well-positioned to understand the impact and ramifications of the proposed ASU on a broad spectrum of derivative end users and share the following comments and recommendations from that perspective.

In general, Chatham is supportive of the FASB’s efforts to improve and simplify the accounting for financial instruments and derivatives and hedging activities in a comprehensive fashion. Given our role as a hedging advisor, our comments will focus primarily on the revisions to the accounting for derivatives and hedging activities. However, broadly speaking, we do believe that both fair value *and* amortized cost are relevant measurement attributes and are concerned with what we believe is an unnecessary expansion of fair value measurements for certain assets and liabilities, including most debt instruments, finance receivables, loans held for investment purposes by financial institutions, and core deposits.

We strongly support fair value as a measurement attribute for derivative instruments, trading assets and liabilities, assets held for sale, and most investment securities. However, if an entity has a business strategy of collecting or paying contractual cash flows on financial instruments (as is the case for most debt instruments, finance receivables, loans held for investment purposes by

financial institutions, and core deposits), we believe that it is in the best interest of both preparers and users of financial statements to measure those instruments at amortized cost, as such information is decision-useful, reliable, cost-effective to provide, and consistent with how the business is managed. Based on our direct experience with debt management and valuations, we are also concerned with the operational challenges and significant subjectivity in modeling unobservable inputs (for example, credit spreads for private companies and small businesses), which we believe will create unnecessary volatility and significant inconsistency in practice. Accordingly, we continue to believe that disclosure of fair value in the notes to the financial statements is sufficient for many types of financial instruments.

Overall Comments on Derivatives and Hedging

Positive Aspects of the Proposed Hedge Accounting Model

Chatham is supportive of the FASB's efforts to simplify the accounting for hedging activities, retain the bedrock "bifurcation-by-risk" model, relax the qualifying criteria for applying hedge accounting, and resolve various practice issues with respect to derivatives and hedging activities. In particular, the importance of maintaining a hedge accounting model that permits the identification and hedging of discrete risks cannot be overstated. On that basis alone, we believe the currently proposed hedge accounting model will be operational for most companies, and we greatly appreciate the FASB's re-deliberations on that issue relative to the 2008 Exposure Draft.

In addition, we believe that the guidance in paragraphs 118 and 126 of the proposed ASU will simplify the hedge accounting model for cash flow hedging relationships with slight timing mismatches between the hedging instrument and hedged forecasted transactions. The use of a single hypothetical derivative for purposes of assessing effectiveness and measuring ineffectiveness in those situations is an appropriate practical accommodation in our view. Similarly, we strongly agree with the guidance in paragraph 124 of the proposed ASU regarding use of the same credit risk adjustment on the hypothetical derivative as that used in calculating the fair value of the actual hedging derivative. We believe both of those provisions are very reasonable accommodations that will resolve lingering practice issues and simplify the application of hedge accounting.

Finally, we agree with the proposal that entities should be permitted to use total changes in cash flows or intrinsic value when measuring ineffectiveness related to a purchased option used as the hedging instrument in a cash flow hedge, although we recommend that the FASB clarify what it means by "rational basis" for amortization of the option premium. That is, it is not clear to us how the FASB intends for option time value to be amortized to earnings over the life of the hedge, including whether straight-line amortization would be permitted or whether the amortization approach should continue to be based on a methodology similar to ASC 815-30-35-36 (DIG Issue G20), in which allocated fair value amounts are reclassified from other comprehensive income to earnings when the associated hedged forecasted transactions affect earnings. Conceptually, we believe that the guidance provided in DIG Issue G20 is the most theoretically sound and should be expressly permitted.

Areas of Concern with the Proposed Hedge Accounting Model

Our principal areas of concern with respect to the proposed changes to the hedge accounting model are (1) the inability to dedesignate hedging relationships and (2) the changes to how ineffectiveness is recognized for cash flow hedges. In particular, we believe that restricting an entity's ability to dedesignate hedges is a major step in the wrong direction and will create a host of practice issues and problems, in addition to substantially increasing transactions costs. Our detailed comments on this issue are provided in the Appendix below in response to Questions 63 and 64. With respect to ineffectiveness on cash flow hedges, although we do not foresee any operational constraints with respect to recognizing ineffectiveness for both overhedges and underhedges, we believe the current model has a stronger theoretical foundation and is consistent with existing and anticipated IFRS guidance in this area. We would be supportive of a change in this area only if the IASB also agreed to the same modification in its guidance. Creating such a fundamental inconsistency in the recognition of hedge ineffectiveness for cash flow hedges between U.S. GAAP and IFRS—when the standards currently are consistent in this area—would be very unfortunate and a disservice to both users of the financial statements and preparers, especially multi-national companies with reporting requirements under both standards.

In addition, we feel that a critical step in the FASB's due process has been ignored by not providing a marked draft of all the proposed changes to ASC 815. The proposed ASU includes only a handful of paragraphs on hedge accounting, leaving many unanswered questions as to how the several hundred pages of current authoritative guidance will be impacted. For better or worse, ASC 815 is all about the nuances, and the details do matter given the strict interpretation of the hedge accounting guidance by auditors and regulators. At present, we have numerous unanswered questions regarding the transition provisions, intercompany hedging, the impact on a large number of specific DIG Issues, required changes to existing documentation, etc. Accordingly, we respectfully request that the Board provide an additional opportunity for users and prepares to comment once the full impact of the proposed changes are known and a marked draft of the complete changes to the codification is provided.

Opportunities to Improve the Hedge Accounting Model

We believe the proposed ASU provides an ideal opportunity to significantly improve the current hedge accounting model. We understand that the FASB may be reluctant to completely revamp the model (which we do not believe is necessary or warranted), but we feel very strongly that a few additional modifications will (1) result in greater convergence between IFRS and U.S. GAAP, (2) resolve significant practice issues and inconsistencies in the guidance, and (3) significantly simplify the accounting for derivatives and hedging activities.

Our primary recommendations include the following:

- Expanding the definition of interest rate risk
- Expanding bifurcation-by-risk to nonfinancial items
- Permitting foreign currency hedging within a consolidated entity

Expanding the definition of interest rate risk

In our view, expanding the definition of interest rate risk is the modification that would have the most significant impact on simplifying hedge accounting, and this would be our top recommendation for improving the hedge accounting model under ASC 815. By permitting preparers to hedge an identifiable and measurable portion of a financial instrument's cash flow or fair value, the U.S. model also would further converge with IFRS.

Specifically, within the cash flow model, we strongly recommend that the FASB expand the definition of interest rate risk to include “separately identifiable and reliably measurable” indices like prime, Fed Funds, and SIFMA. Currently, the cash flow hedge accounting model for hedges of non-benchmark-rate-based assets and liabilities, like prime and Fed Funds, is awkward and unduly complicated. We believe it can be significantly improved in a way that reflects the risk management practices of companies, remains true to the underlying economics, and converges with IFRS. Unnecessary hedge failures occur and hedge ineffectiveness that is unrelated to the business objectives and underlying economics of transactions too frequently results. For example, the accounting for a prime-based swap hedging a pool of prime-based loans should be as straight-forward and intuitive as the accounting for a LIBOR-based swap hedging a pool of LIBOR-based loans. Both strategies are designed only to hedge the risk of variability in an underlying interest rate index, yet one (LIBOR) is allowed to ignore the credit spread on the loans while the other (prime) is forced to consider the credit spread, creating disparate and illogical results in many instances. Similar situations arise with other common indices like Fed Funds and SIFMA. The hedge accounting results and administrative burden for these two very similar types of hedging relationships can be vastly different, which is confusing to preparers and users alike.

Companies generally seek to eliminate the variability in floating-rate assets or liabilities tied to a particular index via interest rate swaps based on those same indices. In our view, the notion of hedges of interest rate risk being restricted to defined “benchmark interest rates”—specifically Treasury rates and LIBOR—creates needless and frustrating hedge accounting complications. From our perspective, expanding the definition of interest rate risk to include any separately identifiable and reliably measurable interest rate exposure is a simple fix that would vastly improve and relieve significant frustration with the current hedging model being so disconnected from the economics.

Similarly, the fair value hedge accounting model could be significantly improved by permitting entities to hedge any separately identifiable and reliably measurable component or portion of a fixed-rate asset or liability, such as the LIBOR component of a fixed rate debt instrument. In the cash flow model, this concept already exists in ASC 815-20-25-18 (DIG Issue G19) – that is, an entity may hedge “the risk of changes in either...the interest element of the final cash flow if interest is paid only at maturity (emphasis added)...or...the total proceeds attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed rate debt.” With the elimination of shortcut and “critical terms match” methods, this issue becomes particularly important. If the proposed rules become final as written, it is likely that many more companies will be applying very complex and nuanced ineffectiveness

measurements (and potentially effectiveness assessments) under a fair value “long-haul” method, which will significantly increase the cost and complexity of applying hedge accounting for those entities.

In our view, given the proposed elimination of the shortcut method, allowing entities to specify an identifiable component or portion of a fixed-rate asset or liability as the hedged risk represents a reasonable accommodation and would provide much-needed relief, as all entities will be required to follow a long-haul approach going forward. In addition, we believe it would better align the risk intended to be hedged with the derivatives available for hedging. Very importantly, it will also enable companies to hedge certain common assets or liabilities for which hedge accounting has, in some cases, been nearly impossible to achieve.

The concern is perhaps best illustrated by considering a plain-vanilla hedge of fixed-rate callable debt. The basis for conclusions in Statement 133 mentions that the Board agreed during its deliberations that hedge accounting should be available for hedges of callable debt, even though the hedging derivative includes an embedded written option (paragraph 397). Even though the Board clearly intended to permit hedges of callable debt, in practice, it is nearly impossible to qualify, since very few hedging relationships pass the strict “written option” test. This is due to the fact that changes in the value of the call option in the debt are impacted not only by changes in interest rates (and associated volatility), but also credit (even holding the inception credit spread constant), whereas changes in the value of the written option in the swap are based solely on changes in interest rates (and associated volatility) – so the call options are almost never perfectly aligned and the written option test, strictly applied, almost always results in failure. Today, in practice, to pass the written option test, the option in the swap must be significantly devalued, distorting the economics of the hedge and creating additional ineffectiveness—assuming the test can be passed without simultaneously causing the overall hedging relationship to fail the “highly effective” criterion. In fact, some companies have been compelled to use a non-callable swap to hedge callable debt and simply hope that the call option will remain largely out of the money based on the absolute level of interest rates. Hedging callable debt is a very common hedging strategy and companies will be extremely limited in their ability to hedge such a basic instrument, particularly once shortcut is eliminated.

In contrast, allowing entities to hedge identifiable and measurable portions of the fair value of an instrument (for example, the LIBOR component of a fixed-rate debt instrument) “aligns” the economics of the swap and debt, since changes in the option values of both instruments then could be based on the identifiable hedged risk (generally changes in LIBOR) and offsetting changes could be demonstrated for all possible changes in the underlying. We believe this is an incredibly important issue—and perhaps one not well understood by many companies at this point. Along those lines, we would welcome the opportunity to discuss these issues in more detail with the Board and staff and would be happy to illustrate the issues highlighted above.

Finally, based on our experience applying IAS 39 with numerous companies, we would note that the IFRS model in this area (that is, the ability to hedge an identifiable and measurable portion of a financial instrument’s cash flow or fair value) has been robust and non-controversial in practice, still requires hedge ineffectiveness to be measured, and substantially relieves the

frustrations caused by the disconnect between the accounting and the economics under the U.S. GAAP model. Accordingly, this would be our single most important recommendation for improving and simplifying the current hedge accounting model under ASC 815.

Expanding bifurcation-by-risk to nonfinancial items

We further recommend that the Board also extend the bifurcation-by-risk model to separately identifiable and measurable components of **nonfinancial items** and allow entities to designate such separable components as the hedged risk in cash flow or fair value hedges. In our view, the distinction between financial and nonfinancial items is arbitrary, confusing, and unnecessary. For example, many companies have exposure to changes in the price of commodities and prudently mitigate these exposures through the use of derivative instruments, similar to the mitigation of interest rate or foreign currency risk in financial items.

Importantly, such hedges provide clear and identifiable offset to changes in the price of the specified components of the nonfinancial items. One example would be a company entering into an aluminium forward purchase contract to hedge the major component cost of an aluminium-based manufactured product. Based on our experience, basis differences and sources of ineffectiveness between the aluminium forward contract and the aluminium component of the hedged item can be clearly identified and measured in such hedging strategies. Under the current guidance, however, the entity would have to assess the effectiveness of the hedge by evaluating the degree of offset between the cash flows on the aluminium forward contract and the *overall variability* in all cash flows on the entire manufactured product – which generally includes other ingredients and components. Ultimately, such a straightforward strategy may not qualify as an effective hedge. If it does qualify as “reasonably effective” (we acknowledge that the reduced threshold will help with hedge qualification), it generally will still result in significant earnings volatility related to the unhedged components.

Finally, we note that expanding the bifurcation-by-risk model to nonfinancial items likely will result in international convergence on this issue, as the IASB has tentatively concluded through its deliberations that a contractually specified and reliably measurable nonfinancial risk component is a permitted hedged risk.

Permitting foreign currency hedging within a consolidated entity

For consolidated financial statements, as currently written, ASC 815 only allows companies to designate foreign currency cash flow hedges if either (1) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (2) another member of the consolidated group that has the same functional currency as that operating unit is a party to the hedging instrument. Also, to qualify for applying the above guidance, there may not be an intervening subsidiary with a different functional currency. Although an intercompany derivative may be used as a hedging instrument (if certain criteria are met), hedge accounting may be applied only to transactions that are denominated in a currency other than the hedging unit’s functional currency. This provision is helpful for hedging foreign currency risk at the subsidiary level, but

does not address a fundamental problem related to foreign currency risk that results from consolidation of foreign subsidiaries.

Consolidation of foreign subsidiaries presents an earnings exposure in the parent company's financial statements as revenues and expenses must be translated into the functional currency of the parent company at prevailing foreign currency exchange rates. Such translation creates volatility in the parent company's earnings due to variability in foreign exchange rates that is not hedgeable (in any practical manner) under the current hedge accounting model. ASC 815 currently prohibits a parent entity from applying hedge accounting to hedges of a subsidiary's recognized asset or liability, unrecognized firm commitment, or (of particular interest) forecasted transaction if the subsidiary's functional currency differs from that of the parent. This restriction is inconsistent with the manner in which numerous multi-national companies manage their exposure to foreign currency risk related to foreign subsidiaries, many of which evaluate and manage their foreign currency risk based on the functional currency of the parent.

We strongly suggest that the Board consider modifying the above restrictions in the final version of the proposed ASU in a manner that would allow a parent company to hedge its earnings exposure related to the consolidation of a foreign subsidiary. Such modifications would further converge ASC 815 with IAS 39, which currently provides significantly more flexibility for hedging within a consolidated entity. In addition, such modifications would better align foreign currency hedge accounting with the manner in which most companies quantify and economically seek to hedge their foreign currency risk.

Our responses to specific hedge accounting questions (Questions 56 through 58 and Questions 61 through 64 are included in the Appendix below).

We thank the Board for its consideration of our comments and recommendations and would be pleased to discuss these issues in more detail with the Board or staff at your convenience. Please do not hesitate to contact me at (484) 731-0235 or at cmaxwell@chathamfinancial.com should you have any questions or desire further clarification on the topics discussed in this letter.

Sincerely,

/s/ Clark B. Maxwell

Clark B. Maxwell
Director of Accounting Services
Chatham Financial

APPENDIX

Question 56: Do you believe that modifying the effectiveness threshold from *highly effective* to *reasonably effective* is appropriate? Why or why not?

We support the Board’s decision to reduce the threshold to qualify for hedge accounting from a “highly effective” standard to a “reasonably effective” standard. We believe this will simplify the hedge accounting model and reduce the need for complicated statistical analysis for many basic hedging strategies. Additionally, we do not believe this modification will lead to abuse in practice, given that hedge ineffectiveness in all cases will be required to be recognized in earnings and because companies are economically motivated to construct hedging relationships that will be as effective as possible in providing offset to the economic exposure they seek to reduce.

However, due to the subjective nature of the term “reasonably effective,” we recommend that the Board provide examples illustrating the guiding principles that the Board would like preparers to consider in determining whether a hedging relationship is “reasonably effective.” We believe that a few basic examples or an outline of broad criteria would help simplify the application of hedge accounting in practice by reducing the potential for interpretation risk and second guessing by auditors and regulators.

Question 57: Should no effectiveness evaluation 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? Why or why not?

Although we could support either approach, we would prefer that no effectiveness evaluation be required under any circumstances after inception as long as it is determined at inception, through qualitative or quantitative testing, that the hedging relationship is expected to be reasonably effective through its term. We believe that many of the practice issues that have arisen would be resolved if the requirement to periodically test effectiveness were removed and that the ongoing administrative burden of applying hedge accounting would be lightened. We believe the requirement to determine at inception whether a hedging relationship is reasonably effective will prevent entities from structuring hedging relationships between derivatives and hedged items with no clear economic link (e.g., using an interest rate swap to hedge tire inventory) and would eliminate concerns surrounding the potential for entities to use hedge accounting as a fair value option. We also believe there are many natural incentives to structure hedging relationships that are highly effective because of the potentially significant impact on earnings if hedging relationships are poorly designed (since all hedge ineffectiveness throughout the life of the hedge must be recognized in earnings). In our opinion, removing the requirement to perform ongoing assessments of effectiveness will not increase entities’ tolerance of recorded ineffectiveness, it will merely remove the cost and burden associated with performing additional (and sometimes completely unnecessary) work.

In addition, eliminating the ongoing effectiveness evaluation would certainly simplify hedge accounting by removing questions and interpretative issues surrounding what “changes in circumstances” warrant a reassessment of hedge effectiveness. Furthermore, we would note that there are additional qualifying criteria that we believe will provide sufficient hedge accounting guard rails on an ongoing basis (such as the requirement for ongoing qualification for cash flow hedge accounting that the designated forecasted transaction remain probable to occur) once the initial evaluation of effectiveness is performed.

Finally, similar to our response to Question 56, if the Board ultimately decides to issue final guidance that retains the requirement to reassess effectiveness if changes in circumstances suggest the hedging relationship may no longer be reasonably effective, we encourage the Board to provide illustrative examples of such circumstances, which we believe may alleviate a number of practice issues in the future.

Question 58: 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? Why or why not?

In general, we 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 (although, as noted in our response to Question 57, we question the need for any ongoing evaluation of effectiveness). In particular, we believe that such a change would eliminate the long-standing issue of hedging relationships being discontinued as a result of failing effectiveness testing due to the “law of small numbers” problem, which often occurs when there has been little or no change in the underlying variable being hedged and the hedging entity relies on a dollar offset test to assess effectiveness. However, most companies have already dealt with this issue by utilizing regression analysis or other statistical methods to perform their effectiveness assessments (which alleviates the law of small numbers issue), so the benefit today would apply to a much smaller subset of companies.

That said, to the extent that the lower effectiveness threshold reduces the reliance on regression analysis and other statistical methods of assessing effectiveness (which are often overkill and employed simply to avoid hassles like the law of small numbers problem), such a provision could be quite helpful going forward—especially if the Board retains any type of effectiveness testing requirement after the initial assessment.

Question 61: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for cash flow hedging relationships? If yes, what constraints do you foresee and how would you alleviate them?

As mentioned above, we believe that the guidance in paragraphs 118 and 126 of the proposed ASU will simplify the hedge accounting model for cash flow hedging relationships with slight timing mismatches between the hedging instrument and hedged forecasted transactions. The use of a single hypothetical derivative for purposes of assessing effectiveness and measuring ineffectiveness will reduce the operational and administrative challenges. Similarly, we strongly agree with the guidance in paragraph 124 of the proposed ASU regarding use of the same credit risk adjustment on the hypothetical derivative as that used in calculating the fair value of the actual hedging derivative. We believe both of those provisions are very reasonable accommodations that will resolve lingering practice issues and simplify the hedge accounting model.

In addition, we do not foresee any operational constraints with respect to recognizing ineffectiveness for both overhedges and underhedges; however, we do believe the current model has a stronger theoretical foundation and is consistent with existing and anticipated IFRS guidance in this area. From a conceptual standpoint, we are concerned that in a cash flow hedge, *nonexistent* gains and losses (based on a hypothetical derivative that was never executed) that arise solely based on management's expectations of forecasted transactions would be recognized in earnings. Essentially, we share the concern expressed by the Board in Statement 133's Basis for Conclusions relative to recognizing ineffectiveness for "underhedging" in cash flow hedging relationships, that is, that doing so would be inappropriate because "the result would be to defer in OCI a nonexistent gain or loss on the derivative and to recognize in earnings an offsetting nonexistent loss or gain." That said, we do not view this as a "fatal flaw" issue—as long as there is convergence on this issue between U.S. GAAP and IFRS. As mentioned above, we would be supportive of a change in this area ONLY if the IASB also agreed to the same modification to the guidance. We feel strongly that creating such a fundamental inconsistency in the recognition of hedge ineffectiveness for cash flow hedges between U.S. GAAP and IFRS—when the standards currently are consistent in this area—would be very unfortunate and a disservice to both users of the financial statements and preparers, especially multi-national companies with reporting requirements under both standards.

Lastly, we believe that paragraph 122 of the proposed ASU technically needs to compare "the [cumulative] change in fair value of the actual derivative" with "the *cumulative change in the present value* of the expected future cash flows on the hedged transaction"—and NOT "the *present value of the cumulative change* in expected future cash flows on the hedged transaction."

It may seem nuanced, but the wording directly impacts the calculation and the ultimate ineffectiveness recorded in earnings. To provide for an “apples to apples” comparison (which we presume is the FASB’s intention), the first sentence of paragraph 122 should read as follows [text added is underlined and text deleted is ~~stricken~~].

122. The measurement of hedge ineffectiveness shall be based on a comparison of the cumulative change in fair value of the actual derivative designated as the hedging instrument and the ~~present value of the cumulative change in~~ cumulative change in the present value of the expected future cash flows on the hedged transaction.

Question 62: Do you foresee any significant operational concerns or constraints in creating processes that will determine when changes in circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness at each reporting period? If yes, what constraints do you foresee and how would you alleviate them?

As mentioned above, we would prefer that no effectiveness evaluation be required under any circumstances after inception because (1) hedge ineffectiveness would be calculated in all circumstances, which simultaneously provides transparency in the financial statements and motivates companies to design effective hedges and (2) because practice issues such as this could be simplified or avoided by removing that ongoing requirement.

However, if the FASB does require a periodic or triggered reassessment of hedge effectiveness, we do not foresee preparers encountering significant operational concerns or constraints creating processes that would help them determine when changes in circumstances suggest that a hedging relationship may no longer be reasonable effective. Operational concerns particularly would be alleviated if that reassessment were required only under rare circumstances, such as when there is a material modification to either the hedging instrument (including adding a new derivative per paragraph 121 of the proposed ASU) or the hedged item that significantly weakens the economic link between the hedging instrument and associated hedged item or transaction.

Question 63: Do you foresee any significant operational concerns or constraints arising from the inability to discontinue fair value hedge accounting or cash flow hedge accounting by simply dedesignating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?

Yes. We believe that restricting an entity’s ability to voluntarily remove the designation of an effective hedging relationship after it has been established is a major step in the wrong direction and will create a host of practice issues and problems. We foresee numerous operational concerns with this modification to the guidance, including a substantial increase in cost and complexity, and are equally concerned with the negative unintended consequences that will inevitably result from this prohibition.

We work with hundreds of companies in a wide variety of industries and have not seen—and are not aware of—any abuse in this area (supposedly a “tool for changing measurement attributes and/or managing the classification of certain items reported in net income” per paragraph BC222 of the proposed ASU), which makes the proposed modification particularly perplexing. Nor do we believe that auditors, regulators, or users have identified this as an area of concern. As such, this proposed restriction feels like an overreaction and attempted “fix” to an area that isn’t broken. If an isolated abuse does in fact exist in practice, we believe a much more surgical response is warranted (for example, enhanced disclosure of whatever specific concerns prompted the proposed change). From our perspective, however, a sweeping prohibition that completely eliminates an entity’s ability to remove the designation of an effective hedge would be very unfortunate and does not pass the most basic cost-benefit analysis.

Many prudent and legitimate hedging strategies involve dedesignation of the hedging relationship at some point. A few examples include: (1) hedges of a floating rate liability or asset with an interest rate cap or floor for a period of time, after which the entity may desire to remove the hedge designation of the original option so that a new “at-market” option can be designated in its place (for example, assume that an entity capped its LIBOR-based debt a few years ago at 6% when interest rates were high; now, in today’s interest rate environment after interest rates have fallen substantially, the entity may desire to remove the designation of the “worthless” 6% cap and designate a new 1% cap in its place); (2) hedges of foreign-currency-denominated sales/purchases and desired dedesignation of the derivative hedging instruments upon recognition of the resulting receivables/payables to be remeasured under ASC 830 (Statement 52)—a particularly common strategy for entities seeking to hedge foreign currency risk; and (3) “delta-hedging” strategies and dynamic portfolio hedging strategies with pools of hedged items. Given companies’ fundamental need to voluntarily designate and dedesignate hedges as risk management profiles change, the economic environment changes, and the mix of assets and liabilities (and their measurement attributes) on the balance sheet changes, etc., we urge the FASB to reconsider this proposed modification to the existing guidance.

Finally, we believe that no longer allowing an entity to discontinue fair value or cash flow hedge accounting by removing the designation of a hedge will create significant confusion in practice. As an example, paragraph 121 of the proposed ASU states that “an entity may modify the hedging instrument for an existing hedging relationship by adding a derivative to that existing hedging relationship that would not offset fully the existing hedging derivative and would not reduce the effectiveness of the hedging relationship.” From our perspective, adding to or otherwise adjusting the hedging instrument(s) in a hedging relationship clearly establishes a new hedging relationship—and seemingly could not be accomplished without first dedesignating the existing hedging relationship and then establishing a new hedging relationship. If such activity is permitted under the new guidance (presumably because that situation is not considered “removing the designation” of an effective hedge), questions will arise regarding whether and when an adjustment to the hedging instrument (for example, a novation of a trade from one counterparty to another counterparty) or to a hedged item or pool of hedged items constitutes a prohibited “dedesignation” event vs. an “enhancement” or “update” or “modification” of the existing hedge documentation. It would seem to be a slippery slope that likely will lead to many practice questions, interpretation risk, and increased complexity.

Question 64: Do you foresee any significant operational concerns or constraints arising from the required concurrent documentation of the effective termination of a hedging derivative attributable to the entity's entering into an offsetting derivative instrument? If yes, what constraints do you foresee and how would you alleviate them?

Yes. Requiring the effective termination of the hedging instrument by entering into offsetting derivatives will dramatically increase transaction costs for end users, increase credit risk, and complicate the hedge accounting model. The increased cost and complexity also would seem to contradict the FASB's stated objectives for this project.

Clarification regarding the phrase *fully offset* is critical. An off-market (non-zero fair value) derivative with the same counterparty seemingly would be required to fully offset the effect of a hedging instrument. Based on our experience, particularly during the credit crisis, such a requirement is not operational and sometimes would not even be possible in the marketplace. For example, the credit risk policies of the dealer counterparty to a derivative may preclude it from executing an offsetting derivative with the end user, as some policies restrict or even prohibit off-market transactions with specified end users. When it is possible, it would generally create a substantial liquidity event for end users (when they are in a liability position), in addition to significantly increasing transaction costs—even when the dealer counterparty is in the loss position (as dealer-imposed “funding charges” will deeply discount the asset values to end users). Consequently, we have serious economic concerns about our clients being captive/ beholden to the counterparty to the derivative that they desire to “effectively terminate.”

While we disagree with the Board's proposal to prohibit voluntary dedesignation, if the FASB decides to retain that provision, we strongly recommend that the criteria for effective terminations permit an entity to enter into an at-market derivative with any counterparty that offsets the market risk associated with the original derivative. Although the cash flows of the original and offsetting derivative will not *fully offset*, the underlying market risk will be eliminated, leaving only a pay-fixed or receive-fixed annuity. (For the absence of doubt, when the final guidance is drafted, we recommend not using the phrase *fully offset* at all and instead would recommend phrasing such as “a derivative that offsets the market risk of the hedging derivative instrument,” with additional clarification that an existing off-market hedging derivative is permitted to be offset via execution of an at-market derivative and that use of the same counterparty is not a requirement to achieve effective termination.) Such a clarification is crucial so that competitive pricing—rather than captive pricing—is available to end users, thereby reducing (although not eliminating) the substantial transaction costs that will be incurred in complying with the proposed guidance in this area.