April 25, 2011

Ms. Susan Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Via email: director@fasb.org

File Reference: No. 2011-175

Re: Invitation to Comment – Selected Issues about Hedge Accounting

Dear Ms. Cosper:

State Street Corporation (“State Street”) appreciates the opportunity to respond to the FASB’s Invitation to Comment – Selected Issues about Hedge Accounting. With $22.6 trillion in assets under custody and administration and $2.1 trillion in assets under management as of March 31, 2011, State Street is the world’s leading provider of financial services to institutional investors.

We previously submitted comments concerning the FASB’s Proposed Accounting Standards Update – Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities, and we appreciate this renewed opportunity to comment further on the proposed changes to the accounting guidance on hedge accounting. As we noted in our earlier comments, we support the FASB’s continued efforts to improve the decision usefulness of financial statements for users by simplifying and harmonizing the accounting for financial instruments. We support many of the proposed changes to hedge accounting, although we have some concerns with respect to certain aspects.

Effectiveness Evaluation

State Street supports the proposal to require that hedge relationships be “reasonably effective,” as opposed to the current requirement that such relationships be “highly effective,” as well as the proposal to require that, after inception, an entity assess the effectiveness of a hedge on a prospective basis and on a retrospective basis only if changes in circumstances suggest that the hedging relationship may no longer be reasonably effective. The time and resources necessary to analyze and ensure a highly effective relationship are burdensome and discourage hedge accounting altogether.

Furthermore, these proposed changes would provide a principles-based framework, thus removing the bright lines currently used in effectiveness evaluations and removing the risk of falling in or out of effectiveness when quantitative test results are near a bright line. Simplifying the process will encourage more use of hedge accounting, which will ultimately improve the usefulness of financial statements, since the statements would better reflect how entities conduct their operations and risk management activities.
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De-designation Prohibition

State Street is concerned with the FASB’s proposal under which de-designation of a hedging relationship would occur only when the qualifying criteria are no longer met, and an entity would be precluded from de-designating a hedging relationship if the entity changes its risk management objective but the qualifying criteria continue to be met. Given that the improvements to the hedge accounting guidance are meant to better align the accounting rules with entities’ risk-management activities, it seems that the prohibition against de-designation would be in direct conflict with that objective, and instead could potentially lead to increased risk behavior.

Hedging various risks, both for specific risk and overall “macro” portfolio levels, is inherently dynamic and is a process that requires financial institutions to continually react to their business strategy, the economic environment, and counterparty developments. However, the de-designation prohibition ignores this asset/liability management process. By requiring, in order to de-designate the hedging relationship, that the qualifying criteria are no longer met or that the hedging instrument be sold, terminated, or exercised, the FASB appears to be implying that the asset/liability management process is static or that offsetting positions can always be easily executed in a cost effective manner. Unfortunately, this is not the case. In fact, the process to merely enter into offsetting positions creates potentially significant operational difficulties, as the accounting for the instrument must track ever-expanding portfolios of “dead” positions – open positions that offset (or are offset by) other positions. Furthermore, an entity may like the economic exposure provided by a certain derivative contract designated in a particular hedge relationship, and upon de-designation the entity may want to utilize that derivative to manage a risk exposure elsewhere in the organization, rather than being forced to unwind that position. As a result, higher-than-necessary costs are introduced into the hedge accounting process without any measurable economic benefit; this appears to contradict the FASB’s efforts to streamline the hedge accounting process.

We understand the FASB may be concerned about the potential for earnings manipulation if entities are able to voluntarily de-designate hedge relationships. However, we feel that an outright prohibition of voluntary de-designation would be an overreaction, and the FASB’s concern about earnings manipulation stems from isolated cases of derivatives abuse by a select few financial institutions, which are not representative of the sound risk management activities undertaken by the majority of financial institutions. Concerns about earnings manipulation would be better addressed by increased transparency through enhanced disclosure of de-designation activities, rather than a complete outright prohibition of voluntary de-designations.

Conclusion

We support the FASB’s goal of seeking a single set of high-quality, international accounting standards that entities worldwide would use for both domestic and cross-border financial reporting, and its collaborative efforts with the IASB. We urge the FASB to continue its efforts toward convergence and consideration of our points above prior to issuance of a final standard on financial instruments. We appreciate your consideration of these matters and welcome the opportunity to discuss them with you.

Sincerely,

James J. Malerba  
Executive Vice President and Corporate Controller