March 1, 2007

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

Via Electronic Mail: director@fasb.org

File Reference Number: 1510-100

Re: Proposed Statement of Financial Accounting Standards, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133.

Dear Sir/Madam:

Standard & Poor’s Ratings Services (Standard & Poor’s) welcomes the opportunity to provide the Financial Accounting Standards Board (the Board) with comments on the Proposed Statement of Financial Accounting Standards, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (Proposed Statement). The views expressed in this letter represent those of Standard & Poor’s Ratings Services, and do not address, nor are they intended to address, the views of The McGraw-Hill Companies. Further, we address our comments to analytical needs and expectations of credit analysts.

We strongly support the Board’s objective to improve the disclosure and transparency of derivative instruments and hedged items in the financial statements. The Proposed Statement will make financial statements more complete, understandable, and useful for analysis of financial information. We believe the increased disclosure prescribed by the Proposed Statement will considerably improve current financial reporting.

Given the extensive use of derivatives by many of the companies whose debt we rate, and the potential that derivatives can meaningfully alter their business, financial and liquidity characteristics, robust disclosure of derivatives activities is essential to our credit analysis. (The enclosed article, Increasing Derivative Use By Corporate Issuers Calls For Closer Scrutiny, provides further details on key analytical considerations in our evaluation of derivative use by corporate issuers.)
The disclosures mandated by the Proposed Statement would provide important information to analysts in areas where disclosures substantially lacked in the past, such as the location of derivative gains and losses in the financial statements. We nonetheless believe the Proposed Statement falls short in fully meeting its first objective listed in paragraph 1(a) – i.e., providing an “enhanced understanding of ... how and why an entity uses derivative instruments.” To meet this objective fully, we believe disclosures about derivative use must cover much broader information related to the use of derivative instruments (and nonderivative instruments), and be provided in conjunction with information about the reporting entity’s risk-management and asset-liability management practices—necessary to put derivative use in the appropriate analytic context. Disclosures should provide information on risk management activities and asset-liability management practices whether or not used in qualified “accounting” hedge relationships under Statement 133 and include information on how derivative activity relates to the business and financial activities of the enterprise. Given the recent issuance of the Fair Value Option Statement¹, which likely will result in many derivatives not accounted for under Statement 133, we believe a broader disclosure framework related to asset-liability management and hedging practices is even more important. These disclosures should encompass both historical perspective and forward looking information related to risk management practices. Such broader disclosures will provide greater utility to analysts, especially when coupled with the disclosures enumerated in the Proposed Statement.

We understand the Board’s rationale in limiting this project’s scope and its objective to make intermediate progress and meet the deadline of issuing a final standard by June 30, 2007. Our analysts will benefit from the increased disclosure. Accordingly, we encourage the Board to issue a final statement as soon as practicable, while pursuing a longer-term project on broader risk management disclosures. However, consistent with our views that it is essential for financial statements to provide robust disclosures about all of the risks that a company faces, we suggest the Board consider mandating—rather than merely allowing—the following additional disclosures as part of finalizing this Proposed Statement:

- **Disclosure of the overall risk management profile** – Given the potential of an entity’s derivative activities to modify reported financial position; results of operations; and cash flows and the efficacy of past financial data as an analytical tool in forecasting future performance and liquidity, disclosures that allow analysts to understand the overall risk-management characteristics of an entity should be a primary objective of financial statements. In our view, these disclosures should encompass:

  - Risks faced by companies,
  - How they manage these risks; and
  - How and to what extent companies can decrease, modify, or increase risk using derivatives or other asset-liability management practices.

We encourage the Board to require disclosure of an entity’s overall risk-management profile. Because the optional quantitative and qualitative disclosures of Statement 133 permit disclosure of such information, it is not a new or radical idea. This disclosure should include

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derivatives accounted for under Statement 133, and nonderivatives or instruments exempted from derivatives accounting, yet have characteristics that may expose the enterprise to conceptually similar risk-reward characteristics (e.g., derivatives accounted for under Statement 159, derivatives subject to the “normal purchases and normal sales” exception, and equity derivatives on the entity’s own shares that are accounted for pursuant to EITF Issue 00-19).

- **Inclusion in the table(s) of all “hedged items”** – This should include hedged items not in qualifying or designated hedging relationships. Unless disclosures include all hedges, whether qualifying, designated, or not, the disclosure tables will present an incomplete picture of risk management. This is especially true because hedge accounting is optional. To be sufficiently insightful to analysts, disclosures also should capture “natural hedges” (i.e., hedges effected through nonderivative instruments or positions). Because the Board allows these to be provided as part of the narrative disclosures pursuant to the Proposed Statement (we understand these disclosures to be optional), we believe inclusion in a table or in a similar format will be better understood and enhance the “user-friendly” nature of the disclosures. These items may be provided under a separate caption in the table to appropriately distinguish them from those in a hedge accounting relationship.

- **Disclosure in the table(s) of the type of instrument** – We recommend the Board mandate disclosure of the type of instruments the entity uses (e.g., put or call options, forward contracts, futures, collars, swaptions, etc.) in the table or in a narrative disclosure. The risk-reward characteristics of the various types of instruments are quite distinct, and analysts will benefit from this information. Further, although it may be implicit in the requirements, or optional, disclosure of the instruments’ time horizon is important to understanding how derivatives could affect an entity’s financial position, results, and cash flows over time. These disclosures should be required, and could be provided either in the table or in the narrative.

- **Increased disclosure of how derivatives affect cash flows** – One of the objectives of the Proposed Statement is to provide an enhanced understanding of “(h)ow derivative instruments affect an entity’s financial position, results of operations, and cash flows.” However, the Proposed Statement does not specify disclosures related to the cash flow statement or require additional information about cash flows from derivatives. In our analysis of cash-flow statements, we sometimes find it difficult to determine how derivative activities affect reported cash flows (e.g., where settlement proceeds or collateral received or posted is included in the cash flow statement). We recommend the Proposed Statement also require disclosure of how derivatives affect the amounts reported in the cash flow statement, such as classification and amounts of settlements, margins, and collateral posted or received in each category of the statement.

- **Disclosures of how gains and losses affect recorded value of assets and liabilities in fair-value hedges** – As discussed in Issue 7 in the appendix, we recommend the Board require disclosure of the cumulative effect on balance sheet line items of changes in fair value of assets and liabilities hedged using fair-value hedging. Fair-value hedging can result in similar assets or liabilities recorded on the balance sheet using different methods. We believe it important that analysts understand how derivatives affect the balance-sheet accounts.
We have provided our responses to the specific issues listed in the “Notice to Recipients” and additional comments in the appendix to this letter.

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We thank you for the opportunity to provide our input on the Proposed Statement and would be pleased to discuss our comments further with you or any member of the Board or its staff. If you have questions or require additional information, please contact Neri Bukspan, Managing Director and Chief Accountant or Sherman Myers, Director.

Very truly yours,

Neri Bukspan
Managing Director and Chief Accountant
Standard & Poor’s
neri_bukspan@standardandpoors.com
(212) 438-1792

Sherman A. Myers
Director
Standard & Poor’s
sherman_myers@standardandpoors.com
(212) 438-4229

Enclosure
Appendix – Response to Specific Issues in the Proposed Statement

Scope

**Issue 1** – The Board concluded that prescriptive guidance about how derivative instruments should be presented and classified in the financial statements should be excluded from the project’s scope. Including presentation and classification guidance could potentially delay issuing a standard that would significantly improve the transparency about derivative instruments and hedged items. In addition, various presentation and classification issues related to derivatives and hedged items have an impact on the Board’s current project on financial statement presentation and also would need to be addressed in the context of that project.

Do you agree with the Board’s decision to exclude from the scope of this proposed Statement prescriptive guidance about how derivative instruments should be presented and classified in the financial statements? Why or why not?

Given the current disclosure shortcomings of Statement 133, and the time it may require to undertake and conclude a broader project, we support the Board’s decision to limit the scope of the Proposed Statement to facilitate an expedited issuance of a final standard; however, we hope the Board will consider including, as part as this Proposed Statement, certain additional requirements (enumerated in the body of our letter), that we believe essential for analysts to understand derivative use.

We encourage the Board to address financial statement presentation of derivative instruments in its project on financial statement presentation. In addressing financial statement presentation, we urge the Board to pay particular attention to disclosures of how derivatives affect the cash flow statement. (See our comments on cash flow disclosures under “Increased disclosure of how derivatives affect cash flows” above.) The Board also should consider requiring risk disclosures that will include forward-looking information on derivatives and risk management practices (e.g., sensitivity analyses), such as those provided under the SEC’s “market risk” disclosure rules.

**Issue 2** – Statement 133 applies to both public and private entities. The requirements in this proposed Statement also would apply to both public and private entities.

Do you agree that this proposed Statement should apply to both public and private entities? Why or why not?

We agree that the Proposed Statement should apply to both public and private entities. Given the information needs in our analysis, we do not support different reporting standards for public and private companies. We note that Statement 133 applies to all entities; improved disclosure also should apply to all entities.
Costs of Implementing the Proposed Statement's Disclosure Requirements

**Issue 3** – This proposed Statement would require an entity to provide information on derivative instruments (including, but not limited to, notional amounts and fair value amounts), hedged items, and related gains and losses, by primary underlying risk, accounting designation, and purpose in the tabular format shown in Appendix A.

Do you foresee any significant operational concerns or constraints in compiling the information in the format required by this proposed Statement? Are there any alternative formats of presentation that would provide the data more concisely?

**Issue 4** – This proposed Statement would require disclosure of (a) the existence and nature of contingent features in derivative instruments (for example, payment acceleration clauses), (b) the aggregate fair value amount of derivative instruments that contain those features, and (c) the aggregate fair value amount of assets that would be required to be posted as collateral or transferred in accordance with the provisions associated with the triggering of the contingent features.

Do you foresee any significant operational concerns or constraints in compiling that information for this disclosure?

We do not prepare financial statements, and accordingly are unable to address the operational challenges or implementation costs associated with compiling the necessary information; however, as more fully discussed above, we believe increased disclosure and transparency will add meaningful data that can provide greater insights into, and help our credit analysts increase their understanding of, derivative use and risk-management practices of issuers rated by Standard & Poor's.

Regarding presentation, we believe a tabular format complemented by narrative disclosures is appropriate, particularly given the multidimensional nature of the data; however, it is difficult to fully envision how the table will be presented by an entity with significant derivative usage (which could involve many instruments and hedging and trading activities). The Board should consider—possibly in conjunction with field-testing—providing additional examples addressing more comprehensive derivative usage than provided in Exhibit A of the Proposed Statement.

With respect to disclosures of "the existence and nature of contingent features," we recommend the Board further clarify its intent, because contingent features may relate to numerous aspects of derivative contracts including contingent exercise price, early termination provisions, collateral requirements, and events that trigger payout (e.g., a default under a credit default swap).
Disclosure of Notional Amounts

**Issue 5** – This proposed Statement would require disclosure of notional amounts in tables that also will include fair values of derivative instruments by primary underlying risk, accounting designation, and purpose.

Do you agree that this proposed Statement should require the disclosure of notional amounts? Why or why not?

We support disclosure of the notional amounts. However, while information about notional amounts may be useful to analysts in understanding the magnitude of derivative usage, it may be incomplete or misleading in the absence of more comprehensive information on:

- Risk management (e.g., existence of offsetting positions).
- Type of instrument (e.g., a debt obligation may be hedged by an entity for its duration using a swap or a series of swaptions – in the absence of disclosures of the nature of the instrument and the time horizon, merely providing the notional amount may be misleading).
- Impact of leverage factors on the notional amount.
- Settlement options (e.g., physical, net cash, or optional).
- Potential future exposures and risks (e.g., without providing a linkage to how the notional amount relates to the underlying risk – such as, percentage of risk hedged and the duration of the hedge).

In addition, we suggest the Board require disclosure of average notional amounts that were outstanding during a period when quarter- or year-end notional amounts are not representative of normal activity. This disclosure will help analysts understand a complete picture of derivative activity.

**Issue 6** – This proposed Statement would require disclosure of gains and losses on all derivative instruments that existed during the reporting period regardless of whether those derivatives exist at the end of the reporting period. This proposed Statement would not require disclosure of the aggregate notional amounts related to those derivatives that existed during the reporting period but no longer exist at the end of the reporting period.

Do you agree that this proposed Statement should not require the disclosure of the aggregate notional amounts related to derivatives that no longer exist at the end of the reporting period? Why or why not?

We support disclosure of all gains and losses on derivative instruments that existed during the period. In addition, we believe that disclosure of notional amounts of derivatives that existed during the period but no longer exist at the end of the reporting period would provide additional information on the extent of derivatives used in risk management, especially if the intra-period activity deviates from that observed at the end of the period. (See our comment on Issue 5.)
Disclosure of Gains and Losses on Hedged Items

Issue 7 – This proposed Statement would require disclosure of the gains and losses on hedged items that are in a designated and qualifying hedging relationship under Statement 133. The Board decided that an entity would not be permitted to include information in the tables on "hedged items" that are not in designated and qualifying Statement 133 hedging relationships because "economic hedging" means different things to different people.

Do you agree that information about "hedged items" that are not in designated and qualifying Statement 133 hedging relationships should be excluded from the disclosure tables? Alternatively, should the tables include gains and losses on "hedged items" that are recorded at fair value and are used in hedging relationships not designated and qualifying under Statement 133? Why or why not? Would your answer be affected by the forthcoming FASB Statement on the fair value option for financial assets and financial liabilities, which will provide the option to report certain financial assets and liabilities at fair value?

We believe entities should be able (in fact mandated or encouraged) to disclose information in the table(s) on all "hedged items," including those that are not in qualifying or designated hedging relationships under Statement 133. Unless the disclosures include all "economic hedges" (whether qualifying, designated, or not), the disclosure tables will present an incomplete picture of derivative activities and related risk management practices. We have seen many instances of companies choosing not to use (or precluded from using) hedge accounting, notwithstanding management’s and our analytical view of the appropriateness of a hedge for risk management practices. Examples include the following:

- Hedge accounting may require significant effort to document and test the hedge effectiveness, beyond what may be internally required for risk management purposes. Further, the accounting may prove complex and require specialized expertise, especially for smaller issuers. Some of our rated issuers have indicated their preference to forgo hedge accounting, because they believe the accounting effort is too costly.

- Hedge-accounting requirements are complex and, despite good faith efforts, may result in restatements such as seen by companies in applying the "short-cut method." In these restatements, hedge accounting may not be retroactively corrected and re-designated. In many of these situations, rated issuers have indicated their views of the appropriateness of their risk-management practices, notwithstanding the accounting disqualification.

- Hedges may not always be highly correlated as required by Statement 133. For example, airlines may hedge their jet fuel needs with crude oil or other energy products, where the correlation may not qualify for special hedge accounting yet, in management’s view, is a sufficiently effective economic hedge.

- Companies likely will avail themselves of the “fair value option” now afforded by Statement 159.

We believe disclosure requirements should endeavor to provide users with information that help them understand how the company manages all risks and how all hedges affect results of operations. Without knowing if there are “economic hedges” (and what they hedge), as well as what hedges do not cover (e.g., hedges of only a portion of the risks or those entered into for a limited time horizon – as many hedging positions in fact are) it would be difficult for analysts to
determine the extent that management reduces or increases risks only by using the information provided on qualified accounting hedges. In addition, to provide a more complete and meaningful depiction of derivative usage, we believe that the disclosure requirements should permit (if not mandate, at some point in the future) a discussion of natural hedges that occur in the business. These disclosures could be in the table or incorporated to the text of the footnotes.

In addition, we believe the cumulative effect of changes in fair value of items hedged in designated and qualifying fair-value hedges should be included in the table(s). The proposed disclosures only include the income statement classification and amounts of gains and losses on hedged items recognized in income each period. The application of fair-value hedging results in similar assets or liabilities on the balance sheet recorded using different methods. For example, an energy company may have two barrels of oil in inventory – one hedged using a fair-value hedge and one not hedged. The hedged barrel is recorded at cost plus the changes in its fair value since inception of the fair-value hedge, while the unhedged barrel is recorded at historic cost. Accordingly, we recommend the Board include a requirement to disclose the cumulative effect of changes in fair value recorded on the balance sheet and the related accounts.

Disclosure of Overall Risk Profile

| Issue 8 – Under this proposed Statement, quantitative information about nonderivative instruments used as part of an entity's overall risk management strategy would not be included in the disclosure tables. However, paragraphs 44 and 45 of Statement 133 would permit an entity to provide qualitative and quantitative information about the derivatives included in the disclosure tables as those derivatives (a) relate to the overall context of its risk management activities and (b) are related by activity to other financial instruments. |
| Do you agree that information that could be provided in the qualitative and quantitative disclosures encouraged by paragraphs 44 and 45 of Statement 133 would be sufficient to appropriately inform users of financial statements about the risk management strategies of an entity? If not, should additional information about an entity's overall risk management strategies be provided as part of the tabular disclosure required by this proposed Statement? |

As more fully described in our letter and our comments to the specific issues in this appendix, we believe it essential that financial statements provide robust disclosures about all of the risks that a company faces. Accordingly, we agree with the Board's view on the necessity of this information. Because the information is merely encouraged, we are unable to determine whether actual disclosures ultimately provided "[w]ould be sufficient to appropriately inform users of financial statements about the risk management strategies of an entity." Therefore, we suggest the Board consider mandating disclosure of overall risk management information as part of this project. It is vital to have a holistic understanding of an entity’s risk profile to analyze its use of derivatives and their effects on risk.
Examples Illustrating Application of This Proposed Statement

**Issue 9** – This proposed Statement includes examples of qualitative disclosures about objectives and strategies for using derivative instruments, contingent features in derivative instruments, and counterparty credit risk. Those examples are intended to illustrate one potential way of communicating information about how and why an entity uses derivatives and the overall effect of derivatives on an entity’s financial position, results of operations, and cash flows. The examples are not intended to be construed as the only way to comply with the disclosure requirements.

Are those examples helpful in communicating the objectives of providing information on how and why an entity uses derivatives and on the overall effect of derivatives on an entity’s financial position, results of operations, and cash flows? Or, do you believe those examples would be viewed as a prescribed method to comply with the requirements of this proposed Statement?

We fully support the use of examples to illustrate disclosure requirements. We believe examples increase understandability and add value. We encourage the Board to provide additional examples in the Proposed Statement. Preferably, such additional examples will address more complex derivative usage, including commodity and equity derivatives, different derivative types, and hedging and trading activities. (See also our comment under Issues 3 and 4)

**Amendments Considered but Not Made**

**Issue 10** – The Board considered but decided against requiring additional disclosures as described in paragraphs B55–B63. Those disclosures focused on providing information on an entity’s overall risk management profile, methods for assessing hedge effectiveness, and situations in which an entity could have elected the normal purchases and sales exception.

Do you agree with the Board’s decisions not to require disclosures in those areas? Why or why not?

**Disclosure of Overall Risk Profile (Paragraph B55)** – As more fully described elsewhere in this letter, we believe the Board should mandate disclosure of the overall risk profile and the strategies used to manage risks, as discussed in the optional disclosures found in paragraphs 44 and 45 of Statement 133. This disclosure should include economic and natural hedges. Understanding the overall risk characteristics should be a primary objective of financial statements and footnote disclosures.

**Disclosure of Assessment of Hedge Effectiveness (Paragraphs B57-B60)** – We concur with the Board’s conclusion not to disclose information about the assessment of effectiveness of hedges. The important issue is whether hedges meet the effectiveness requirement to qualify for hedge accounting at origin and throughout the life of the hedge, or why management otherwise believes a hedge is economically effective, notwithstanding the accounting designation. However, material amounts of ineffectiveness gains and losses should be disclosed.
Disclosure of Normal Purchases and Normal Sales Exception (Paragraphs B61-B63) – We believe it is important for analysts to understand when an entity elects derivative accounting in accordance with Statement 133, where it could have elected normal purchase and sale accounting. For example, an energy marketing company may choose not to elect normal sale accounting for sales of energy products to customers, instead electing to mark these contracts to market as derivatives. Consistent with our comments in other areas relative to broader risk management practices, we believe this information and the effects of the election are important to understanding how an entity manages risks.

Effective Date

**Issue 11 – The Board’s goal is to issue a final Statement by June 30, 2007. The proposed effective date would be for fiscal years and interim periods ending after December 15, 2007. At initial adoption, comparative disclosures for earlier periods presented would be encouraged, but not required. Beginning in the year after initial adoption, comparative disclosures for earlier periods presented would be required.**

*Does the effective date provide sufficient time for implementation?*

We support the Board’s proposed effective date. It is important that significant improvements in disclosure and transparency be as timely as possible.
Additional Comments

We provide the following additional comments for your consideration:

Disclosures of Instrument Type

Forwards, futures, and swaps have both upside potential and downside risk; an option, on the other hand, has only a one-sided outcome. Because of the different characteristics of derivatives in their various combinations, it is important to know the nature of the instruments used to understand how derivative may affect financial information. We recommend that the tables also itemize derivatives by type (e.g., forwards, futures, swaps, options, collars, swaptions, and others). In addition, the disclosure should state what the derivative endeavors to accomplish as well as other pertinent information. For example, to understand a collar an analyst needs to know the strike prices and the expiration dates of the options. Without disclosing these terms, and how they relate to existing assets or liabilities or future transactions, it is difficult to understand derivative usage. The Proposed Statement also does not require information about the specific risk being hedged (e.g., type of currency, particular commodity, interest rate benchmark, etc.), the time horizon hedged, and settlement methods and options (e.g., physical delivery, net cash settlement, ability to settle with shares, etc.), all of which we consider essential.

Collateral

We recommend the Board consider including disclosure of collateral in the table or elsewhere in a way that enables analysts to understand the net fair value of a position (often collateral is merely a prepayment). Collateral disclosures should also include:

- Requirements and triggering points;
- Amounts; and
- Types (for example, cash, securities, or letters of credit).

Further, disclosures about collateral should be reciprocal for collateral received and posted. Under section (d) of the Proposed Statement Summary, disclosure of collateral will only be required for derivatives in an asset position. Further under the added paragraph 44E(d) it appears that disclosures related to the "[e]ntity's policy of requiring collateral or other security to support derivative instruments" are required – the Proposed Statement also should mandate disclosures of the reciprocal requirement to post collateral and the circumstances in which the entity may be required to post collateral.
Periods Presented and Format of Table

The sample table provides disclosures only for a single year of balance sheet information and two years of income statement data. Paragraph A4 only requires one year of balance sheet information and two years of income statement data. Commencing with the second year after adoption, we recommend that tables provide comparative disclosures for all periods for which financial statements are provided, consistent with current GAAP practices for other disclosures accompanying the financial statements. For example, a typical disclosure in a filing with the SEC would include two years of comparative balance sheet information and three years of income statement information. We do not believe the extent of the information to be provided should drive the decision about periods for which financial information is required to be disclosed.

In addition, the sample table contains many abbreviations and shortcuts that may be familiar to accountants but may not be as understandable to non-accountants and analysts. We recommend the sample table included in the final statement not use abbreviations.
Increasing Derivative Use By Corporate Issuers Calls For Closer Scrutiny

Publication date: 09-Nov-2005
Primary Credit Analysts: Neri Bukspan, New York (1) 212-438-1792; neribukspan@standardandpoors.com
Jonathan Nus, New York (1) 212-438-3471; jonathan_nus@standardandpoors.com

Derivative instrument use by corporate issuers has increased substantially during the past decade. Derivatives in use range from the relatively generic instruments—such as interest-rate swaps and foreign exchange forward contracts—to more exotic instruments, such as credit default swaps or weather derivatives, as well as derivatives with a leverage factor. Although predominantly used for risk management practices, derivatives also may be used in conjunction with, or in support of, an issuer's trading activities (e.g., derivative trading activities of certain energy companies). In addition, derivative transactions occasionally are entered into for purely speculative or arbitrage purposes. The increasing use of derivative instruments, coupled with the complex nature of the instruments themselves—many of which have yet to be tested under real severe stress conditions—and the relatively opaque accounting and disclosures for derivatives and financial instruments, mandate a closer scrutiny of this area in Standard & Poor's Ratings Services' ratings process.

Derivatives are financial contracts with values linked to the performance of an underlying variable (e.g., interest rate, currency exchange rate, index, security, or commodity price). In their simplified form, derivatives are instruments that provide the holder with the risks and the rewards of owning an underlying asset or financial instrument, without actually owning it. In some cases, derivatives may be leveraged so that a change in the value of the derivative may be significantly larger than the linear effect of the change in the underlying variable would imply. Derivatives also allow companies to limit, separate, and share various kinds of risks or rewards. For example, an issuer may retain the credit risk of a receivable while hedging the underlying currency risk, or alternatively, retain the currency risk while hedging the credit risk.

The use of derivatives can increase or decrease an issuer's credit risk profile. Indeed, issuers may well face large risks as a result of not using derivatives at all. For example, issuers within the U.S. airlines sector often are constrained from entering into derivative instruments because of their poor overall credit quality, and so are exposed to fluctuations in fuel costs. An entity's derivative strategy reflects the organization's level of acceptance of certain risks and must be evaluated in the broader context of the industry structure; the company's business position and financial policies; the availability of effective hedging instruments; the existence of normal operating natural hedges; and the company's overall asset-liability-management (ALM) practices. Certain levels of uncertainty and risks are inherent, regardless of even concerted hedging efforts: it may be virtually impossible, or at least not cost-effective, to use derivatives to hedge 100% of an exposure for the duration of the exposure. Similarly, issuers may find that long-term hedges are not available, or are cost-prohibitive. Likewise, issuers within emerging markets may find that high rates of inflation result in cost-prohibitive derivative instruments (e.g., interest or foreign exchange). Moreover, hedging occasionally means substituting one risk for another (e.g., hedging foreign exchange risk exposes the company to counterparty credit risk).

We have developed a framework to facilitate the assessment of derivative usage by corporate issuers globally. This framework, which gradually will be phased in over the next several months, is intended to identify those issuers with derivative usage (or non-usage) and related risk management practices that warrant further consideration in our ratings process. Given that the assessment process is segmented based on industry and region, it also provides a better perspective from which to analyze how issuers within each segment use (or do not use) derivative instruments, and why. While analyzing the impact of derivatives in the context of the overall credit quality has long been our practice, this framework enables
us to place a systematic and renewed emphasis on this topic, given the growth in derivatives usage.

Standard & Poor's Framework For Assessing Derivatives Usage

Our analytical framework focuses on derivatives use in the context of analyzing the following four risk attributes:

- Business and market environment;
- Liquidity;
- Control and risk management; and
- Financial statements.

This framework requires Standard & Poor's analysts to categorize an issuer within each attribute, based on the perceived level of potential risk, i.e., a given categorization does not necessarily serve as an indicator of actual credit risk, but rather is a prompt to indicate where incremental analytical consideration is warranted. This analytical focus may include obtaining additional information from management on the nature of derivative positions or risk management practices, in order to glean further insights into hedging and risk management practices. This may also include obtaining additional guidance in interpreting the issuers' reported financial information and projections, as well as increased surveillance.

Analytical attributes

The following are the predominant elements of each attribute; Table 1 provides further details on the individual considerations associated with each.

Business and market environment. We consider the overall industry and business characteristics of the enterprise as well as the underlying market risk exposures of the enterprise, both current and prospective. Our evaluation includes such financial issues as potential sensitivity to interest-rate fluctuations, foreign-exchange rate changes and availability, and pricing of commodities and other production inputs. We seek to identify how the fundamental risk exposures of an issuer and its relative market position influence management’s strategy with respect to risk management. Peer analysis plays a critical role. Likewise, risk metrics such as sensitivity analysis are important, enabling us to consider a range of scenarios. In this regard, both qualitative and quantitative risk measures (e.g., value at risk) serve as useful analysis tools.

Our analysis also takes into account natural hedges that exist within the issuers' operations. For example, risks associated with foreign-currency-denominated receivables are offset with same-currency-denominated payables, or price elasticity allowing for a relatively concurrent passthrough of commodity price increases to customers. We also consider the risk appetite of an enterprise, assessing how current derivative positions relate to overall management strategy and how consistent policies in this regard have been in recent years.

Liquidity. We consider the capacity of the enterprise to monitor and meet any short-term liquidity requirements as a result of being a party to a derivative instrument (e.g., as a result of a collateral posting requirement). This requires consideration of liquidity and collateralization triggers, covenants, termination risks, and counterparty credit-worthiness. A growing number of derivative transactions are secured by collateral agreements, allowing for the possibility that derivative counterparties could stand to benefit from a priority claim on an issuer's assets in the event of bankruptcy. Sensitivity analysis also is critical.

Control and risk management. We consider the general risk management practices of the organization, and seek to identify how issuers determine the appropriate risk and liquidity positions for derivative activities. A good understanding of the risk management function is integral to the control and risk management assessment. This encompasses an assessment of management's ability to communicate a clear risk strategy across the organization, its track record with respect to risk management activities, and its board of directors' oversight. In addition, we consider the existence and extent of prudent guidelines containing clear metrics used to establish and monitor risk limits (e.g., value at risk or other sensitivity analysis).

Financial statements. We consider the impact derivative activities have on issuers' reported financial performance, and the significance those positions have on the key analytical ratios used in our ratings.
process (prior to adjustments). The accounting framework for derivatives may cause meaningful divergences in financial reporting effects between an issuer using derivatives to hedge compared with peers that do not hedge; account for their hedges differently (e.g., choose to elect hedge accounting); or that use natural hedges or non-derivative arrangements (e.g., long-term fixed supply contracts) in lieu of using derivatives. These variants may lead to accounting-driven volatility on both the balance sheet and the income statement, which may not necessarily correspond with the underlying economics. Further, with the use of hedge accounting, derivatives may cause cash income measures to diverge from amounts reported on the income statement, and lead to an adjustment in the basis of assets and liabilities that may not necessarily equate to fair value. In addition, with the use of fair value accounting to account for derivatives, it is important to understand the potential effects of aggressive or highly subjective assumptions and estimates. In our analysis, we seek to recognize these issues and, when analytically significant and material, neutralize these accounting effects for credit ratio and comparative purposes. We evaluate the extent to which key financial measures and ratios calculated based on reported amounts are influenced by such derivative accounting treatments. At times, adjustments are made where the analyst determines this makes the resulting measures and ratios more meaningful in the assessment of creditworthiness and the adjustments are practical. In certain cases, where information is readily available, this can be done using quantitative adjustments, while in other cases, where impractical or impossible to reconstruct an equivalent scenario, rough estimates are employed. The extent to which derivative use is influenced by accounting rather than economic considerations is also important to us in our analysis. We also consider the level of transparency involved with derivative instrument-related disclosures. Opaque reporting may influence our view of management as well as serve as a prompt for further inquiries with management.

The key analytical considerations for each risk attribute are outlined in Table 1. Certain occurrences of overlap among these attributes are inherent in this process, where considerations may affect more than one attribute. For example, speculative use of derivatives generally presents business and market environment risk, liquidity risk and financial statement risk. The list is neither all-inclusive nor presented in any particular order.

Table 1

<table>
<thead>
<tr>
<th>Key Analytical Considerations For Derivatives</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business and Market Environment</strong></td>
</tr>
<tr>
<td>General industry characteristics.</td>
</tr>
<tr>
<td>Level of business and financial risk exposures related to interest rates, foreign currencies, commodities, and credit risk.</td>
</tr>
<tr>
<td>Extent of derivatives use for risk management and hedging purposes.</td>
</tr>
<tr>
<td>Extent of derivatives use for speculative or trading purposes.</td>
</tr>
<tr>
<td>Consistency of derivatives use with business strategies, risk profiles, and peers.</td>
</tr>
<tr>
<td>Complexity of derivatives used (plain vanilla derivatives, or highly structured or leveraged derivatives).</td>
</tr>
<tr>
<td>Use of derivatives embedded in non-derivative contracts.</td>
</tr>
<tr>
<td>Existence of significant swings in notional amount of derivatives used in hedging, without corresponding changes in the underlying risks being hedged.</td>
</tr>
<tr>
<td>Sensitivity of the fair value of derivatives to plausible changes in underlying variables.</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
</tr>
<tr>
<td>Existence of trigger, collateral, or early termination provisions.</td>
</tr>
<tr>
<td>Extent of counterparty risks or concentrations, and any unusual security rights provided to counterparties.</td>
</tr>
<tr>
<td>Liquidity profile and the potential impact of derivatives on covenants and cross default provisions.</td>
</tr>
<tr>
<td>Indication whether potential volatility as indicated by value-at-risk or other sensitivity analysis measures could cause liquidity concerns.</td>
</tr>
</tbody>
</table>
Table 1

Key Analytical Considerations For Derivatives (cont.)

<table>
<thead>
<tr>
<th>Controls and Risk Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comprehensiveness of risk management policies and procedures.</td>
</tr>
<tr>
<td>Whether risk management is outsourced or in-house, centralized or decentralized; and indication of size and experience.</td>
</tr>
<tr>
<td>Tone at the top and extent of independent oversight related to derivative use and risk management policy.</td>
</tr>
<tr>
<td>Management practices for approval process and monitoring risk including counterparty risks, collateral requirements, risk limits, and embedded derivatives.</td>
</tr>
<tr>
<td>Market-risk metrics used to monitor and manage risk and significant assumptions (e.g., value at risk).</td>
</tr>
<tr>
<td>Track record of risk management and history of unexplained shifts in derivative and hedging strategy, or presence of large unexpected losses.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impact of derivative positions (including embedded derivatives) on financial statements (balance sheet, income and cash flows statements).</td>
</tr>
<tr>
<td>Relative sensitivity amounts reflected in the financial statements relative to significant estimates made, and the use of aggressive assumptions to determine fair value of derivatives.</td>
</tr>
<tr>
<td>Extent that derivative gains/losses impact ratios used by Standard &amp; Poor's.</td>
</tr>
<tr>
<td>Existence of unusual financial statement volatility arising from the use of derivatives.</td>
</tr>
<tr>
<td>Significance of gains/losses associated with hedge ineffectiveness, or of unexplained, unanticipated, or volatile financial results arising from derivatives.</td>
</tr>
<tr>
<td>Mismatching of reported income or expense and underlying cash flows arising from derivative use.</td>
</tr>
<tr>
<td>Derivative results inconsistent with industry trends.</td>
</tr>
<tr>
<td>Extent to which hedging practices are influenced by accounting, rather than economic considerations.</td>
</tr>
<tr>
<td>Clarity of financial statement disclosures.</td>
</tr>
</tbody>
</table>

The Evaluation Process

Our analysts will apply this framework to industrials and utilities globally. When derivative usage is identified as an important credit consideration, as indicated by one or more of the attributes within the framework, analysts will apply additional analytical procedures as necessary, including:

- Conduct follow-up discussions with the companies to obtain additional information (such as sensitivity analyses and stress tests);
- Meet with risk-management personnel;
- Increase surveillance of liquidity and derivative activities; and
- Evaluate the extent to which key financial measures and ratios calculated based on reported amounts are influenced by derivative accounting treatments and adjust for accounting treatments, when meaningful and practical.

Going forward, the derivative usage assessment for each issuer will become integrated with the ongoing credit surveillance process. We intend to publish additional commentary on this subject and our findings over the next several months.

Additional Contacts:
Santiago Carniado, Mexico City (52) 55-5081-4413; santiago_carniado@standardandpoors.com
Agnes M DePetigny, New York (1) 212-438-7102; agnes_depetigny@standardandpoors.com
Emmanuel Dubois-Pelerin, Paris (33) 1-4420-6673; emmanuel_dubois-pelerin@standardandpoors.com
Sue Harding, London (44) 20-7176-3734; sue_harding@standardandpoors.com
Anton James, London (44) 20-7176-3805; anton_james@standardandpoors.com
Barbara Komjathy, CFA, Toronto (1) 416-507-2550; barbara_komjathy@standardandpoors.com
Solomon B Samson, New York (1) 212-438-7653; sol_samson@standardandpoors.com
Scott Sprinzen, New York (1) 212-438-7812; scott_sprinzen@standardandpoors.com
Ian Thompson, Melbourne (61) 3-9631-2100; ian_thompson@standardandpoors.com