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Director of Technical Application and Implementation Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Re: File Reference No. 1590-100

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LETTER OF COMMENT NO. 41

Dear Director:

We are writing in response to your invitation to comment on the Exposure Draft entitled, "Accounting for Hedging Activities, an amendment of FASB Statement No. 133" ("Exposure Draft").

KeyCorp (Key), headquartered in Cleveland, Ohio, is a bank-based financial services company that, at June 30, 2008, had assets of approximately \$102 billion. At June 30, 2008, Key had \$793 million (gross) of derivative assets and \$188 million (gross) of derivative liabilities that are being used for hedging purposes. As of the same date, Key had trading derivative assets of \$2.4 billion (gross) and trading derivative liabilities of \$2.2 billion (gross). Therefore, the subject matter addressed in this Exposure Draft is of great interest to Key.

We appreciate the opportunity to comment on this Exposure Draft and support the Board's commitment to developing high-quality financial accounting standards and improving comparability of financial information while promoting international convergence of accounting standards. Key takes pride in providing detailed, timely and comprehensive financial information to the investment community, and supports standards and interpretations that clearly result in reliable and relevant information that can improve investor understanding and allow for more informed decisions.

It is Key's belief that the FASB's intent in developing and proposing this guidance is to simplify the requirements around hedge accounting and decrease the accounting risk associated with hedge accounting. However, it is Key's belief that this proposed accounting guidance will have a significant adverse impact on hedge accounting, adding additional volatility and complexity to the hedging practices of companies. Requiring entities to hedge all of the risks in a hedged item/transaction rather than allow an entity to hedge individual risks may create significant volatility in an entity's income statement and potentially force entities to enter into complex hedging relationships to fully hedge all the risks in a transaction.

Balance sheet management, and specifically interest rate risk management, is significant to the ongoing operations of financial institutions. A significant amount of time and energy is devoted to developing strategies to manage one specific type of risk – interest rate risk. One of the key ways to manage interest rate risk is to use derivatives, specifically using hedge transactions to modify the exposure to interest rate risk. This proposed guidance removes the ability for financial institutions to hedge only the benchmark interest rate as the hedged risk in a fair value or cash flow hedge. This proposed guidance, therefore, will have a significant impact on financial institutions, result in industry-wide changes in the application of asset/liability management and add volatility to the income statement in an already volatile environment.

The proposed guidance does simplify the ongoing requirements associated with hedge accounting, with the modification in the requirements for the ongoing effectiveness assessment and modifying the effectiveness threshold from highly effective to reasonably effective. However, without additional information, the proposed guidance does not necessarily result in more meaningful and/or comparable financial statements. It is Key's position that the following items need to be addressed in any final guidance related to hedge accounting:

- Allowing entities to unwind and put on a new hedge in cases where an entity modifies or exchanges debt that does not qualify as an extinguishment.
- The continued ability to designate the benchmark interest rate as the hedged risk in a fair value or cash flow hedge.
- Further definition of "reasonably effective" and the events that would cause an entity to perform a qualitative or quantitative analysis after inception of the hedge relationship.
- The one-time fair value option election.
- The amount of documentation needed at implementation of the new guidance.
- Reconsideration of the effective date based on the volume of changes to the hedging requirements and the time required for implementing these changes.

### Hedged Risk - Entity's Own Debt

The FASB should continue to permit entities to hedge interest rate risk on its own issued debt. This will enable entities to continue to synthetically create variable-rate or fixed-rate debt, which is a key strategy for financial institutions. If the FASB requires that all the risks associated with an entity's debt be designated as part of the hedge relationship as proposed in the Exposure Draft, entities will need to consider their own credit risk. This could be misleading to users of financial statements. For example, if credit spreads of many financial institutions widened dramatically as a result of the current credit crisis, these entities would recognize the financial impact of this widening in the income statement, and a fair value gain would be recognized. The recognition of a gain during a period of perceived or actual financial weakness is confusing and counterintuitive.

As currently proposed in the Exposure Draft, allowing an entity to hedge its own debt only at inception limits an entity's flexibility in managing its risks associated with the debt instrument. One exception the FASB should consider relates to the impact of EITF 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments, on this requirement. If an entity modifies or exchanges a current debt issuance that has been hedged since inception but does not meet the requirements to be accounted for as a debt extinguishment, an entity should be

allowed to unwind the current hedge and put on a new hedge at the time of the modification or exchange. With the modification or exchange transaction, the interest rate risk inherent in the debt instrument may have changed, and entities should have the ability to hedge the new risk profile of the debt instrument.

## Hedged Risk - Benchmark Interest Rates

Elimination of the ability to designate individual risks, especially the benchmark interest rate, as the hedged risk potentially limits a particular entity's risk mitigation strategies. In many cases, an entity's overall risk mitigation strategy employs hedging to manage and minimize their more significant risks (e.g. interest rate risk) while accepting other risks. In fact, many investors are looking for diversification in their overall portfolio driven by the limitation of some risks while being exposed to other risks.

To allow financial institutions to continue to utilize the asset/liability management strategies investors have become accustomed to, Key believes designating a benchmark interest rate as the hedged risk in a fair value or cash flow hedge should be allowed. Interest rate risk is inherent in the banking industry, and financial institutions have developed risk management policies to respond to this risk through various strategies. One such strategy employs using derivatives, predominantly interest rate swaps, to modify the interest rate characteristics of certain assets and liabilities to manage the balance sheet. Introducing additional risks to be incorporated into the hedge relationship as would be required by this proposed accounting guidance will create unnecessary volatility and severely restrict a financial institution's ability to effectively implement balance sheet risk management policies.

How entities manage interest rate risk, particularly financial institutions, is certainly of interest to financial statement users. One of the objectives of this proposed guidance is to improve financial reporting related to hedge accounting and make the results more useful. However, the requirement set forth in the Exposure Draft to hedge all the risks associated with a given hedging relationship when added to an already complicated and sophisticated methodology used by financial institutions to mitigate interest rate risk will distort the economics of the hedging relationship in the entity's financial statements. The proposed guidance results in the unintended consequence of forcing entities to hedge risks they would otherwise accept in the normal course of business. This will force financial institutions to significantly change the way they do business. It is Key's position that financial statement users will not have the information necessary to evaluate a financial institution's ability to manage its interest rate risks.

Another issue with forcing entities to hedge risks in addition to interest rate risk is that some of those risks may already be managed as part of an entity's core operations. For example, financial institutions are in the business of making loans, and these entities have very sophisticated credit underwriting procedures in place to manage the credit risk associated with the loans. In certain instances, financial institutions may enter into a credit default swap transaction to mitigate the credit risk related to a loan. It would be costly and time consuming to enter into credit derivative transactions on each loan in addition to a derivative to mitigate interest rate risk. This would be particularly problematic for small and middle-market customer loans where the credit derivative market is essentially non-existent. Also, current accounting does not allow the calculation of the Allowance for Loan and Lease Losses ("ALLL") to be impacted by the purchase of credit derivatives. Therefore, there will be no direct correlation

between the measurement of the credit risk associated with the ALLL and the credit derivatives entered into to hedge the credit risk in accordance with the guidance in the Exposure Draft. Once again, this would force financial institutions to significantly change the way they do business and would not provide any meaningful guidance to financial statement users on how effectively financial institutions are managing their risks.

In addition, a key financial measurement focus for financial institutions is net interest income. One of the ways most financial institutions manage their interest income and interest expense is by entering into derivatives to hedge the interest rate risk on the related balance sheet assets and liabilities that generate interest income and expense. Key provides extensive disclosures in both its Management's Discussion and Analysis as well as in the footnotes to its financial statements concerning the various strategies employed to manage interest rate exposure, with the most significant strategy being the use of derivatives. For the reasons detailed above, Key recommends that the FASB reconsider the need to eliminate the ability to designate individual risks as the hedged risks and, if that is not acceptable, allow entities the ability to designate a benchmark interest rate.

## Hedge Effectiveness

Key is generally in agreement with the suggested changes to hedge effectiveness. The guidance as proposed should reduce the amount of time and documentation necessary to demonstrate that there is an effective relationship between the hedging instrument and the hedged item or hedged forecasted transaction on an on-going basis. Key does believe, however, that more guidance is needed regarding when an effectiveness evaluation should be performed after inception. Examples or specific events that would require an entity to perform a qualitative and/or quantitative analysis to determine if the hedging relationship is still reasonably effective should be provided. This suggested additional guidance should include information to determine when a qualitative assessment would be required. This would provide for a more consistent approach to determining when effectiveness should be assessed. Based on this type of suggested guidance, entities can create internal policies to reflect the conditions that would need to be present within hedging relationships to determine when a qualitative and/or quantitative assessment should be performed.

This suggested additional guidance will also assist outside auditors in their role in assessing whether an entity should perform additional procedures to assess hedge effectiveness. One practical example relates to hedging the forecasted sale of a pool of loans. While the risk exposure is consistent for the pool of loans, the loans within the pool will be consistently changing as loans move in and out of the pool. The guidance is not specific enough to determine whether effectiveness would need to be evaluated with each occurrence of a change of the loan mix within the portfolio or only if, in the entity's judgment, the hedging relationship may no longer be effective.

Changing the threshold of hedge effectiveness from highly effective to reasonably effective will also decrease the burden on the amount of time spent on effectiveness assessments. In addition, it will reduce the number of hedge transactions that fall in and out of effectiveness over a period of time. However, Key would request that the FASB provide more guidance on what is meant by "reasonably effective" to ensure that the methodology is consistently applied. When SFAS 133 was first issued, there was much confusion as to what constituted "highly effectively," and it

was the SEC that put forth the now standard range of 80% to 125%, which was based on the results of a review that the SEC performed on a registrant at that time. If final guidance is issued without a definition of reasonably effective, entities as well as public accounting firms will need to draw their own conclusions on how to interpret "reasonably effective." This will result in inconsistent methodologies to apply the guidance among entities, differences in judgment decisions between entities and their financial statement auditors, potential restatements if regulators have a different interpretation of reasonably effective, and the burden for entities to reconstruct their methodology if a regulatory body issues a statement at a later date with the definition of reasonably effective.

# Fair Value Option Election

Key is in agreement that the FASB should allow entities to elect a one-time fair value option under Statements No. 156, Accounting for Servicing of Financial Assets, and No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. Providing for the option to elect fair value accounting for those assets and liabilities currently designated as hedged items under Statement No. 133 will allow entities the flexibility of changing their strategy around hedged items based on the new guidance. In situations where an entity determines that it cannot support hedge accounting under the new guidance, entities will have the ability to continue to reflect the financial impact of an economic hedge by recording the previously hedged item at fair value. While this may create additional volatility in an entity's income statement, the impact will not be as significant as if the entity discontinued hedge accounting and kept the previously hedged item at cost. However, the recording of items at fair value has a negative aspect in that it is often difficult to determine fair value, especially during significant market disruptions as seen over the past year. There has been much publicized in recent months about the additional volatility created by fair value measurements.

### <u>Transition</u> – Documentation

The Exposure Draft states that an entity must designate a new hedging relationship if it chooses to apply hedge accounting at implementation of this proposed guidance if finalized, with the exception that the designated risk(s) being hedged are permitted before and after the effective date of the new guidance. Preparing new hedge documentation for each hedging relationship as of the effective date of the adoption of this new guidance will be an extremely onerous task, especially since many entities have spent a significant amount of time and effort since the inception of SFAS 133 to ensure that the appropriate level of formal documentation exists. This will create a lengthy paper trail and is duplicative in nature.

Requiring new documentation when the majority of the current documentation is sufficient will only create unnecessary confusion. Rather than creating new hedge documentation for each hedge on the effective date, Key recommends that the FASB consider allowing entities to create documentation at the effective date to incorporate only the information necessary to prove a hedging relationship exists under the new guidance. The documentation could be done on a "pooled" approach (e.g. by type of risk mitigation strategy, by derivative type, cash flow vs. fair value hedges, etc.) rather than requiring the documentation to be prepared for each individual hedging relationship.

### **Effective Date**

The Exposure Draft, if adopted by the FASB as final guidance, would be effective for fiscal years beginning after June 15, 2009. As this guidance may have a significant impact on an entity's operations and how it manages certain risks, as well as the additional documentation required at the transition date, Key believes that entities should have one year from the date the final guidance is issued to implement the new guidance. Entities will need time to analyze the new requirements for hedge accounting and conduct a cost-benefit analysis to determine the best course of action. As previously stated, entities may need to adopt Statement No. 159 if they choose not to implement the new Statement No. 133 provisions, which will require entities to determine a fair value methodology for the respective previously hedged items and prepare the necessary disclosures.

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We hope these comments are useful and positively influence the final guidance. We welcome the opportunity to discuss this issue in more detail. Please feel free to contact Bob Morris, who is our Chief Accounting Officer, at 216-689-7841 or me at 216-689-4082.

Sincerely,

Charles L. Maimbourg Senior Vice President Director of Accounting Policy & Research