Chatham Financial

August 13, 2008

LETTER OF COMMENT NO. 12

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

Re: File Reference Number 1590-100, Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133*

Dear Mr. Golden:

Chatham Financial ("Chatham") is pleased to comment on the Financial Accounting Standards Board's ("FASB") Exposure Draft of Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133* (the "Exposure Draft" or "proposed Statement"). Chatham serves as a hedging advisor to over 500 companies in many different industries. Over 250 of our clients regularly apply Statement 133 and will be subject to the provisions of the new standard. Chatham assists its clients with the implementation of Statement 133 on a daily basis for thousands of derivative transactions, including providing assistance with 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 Statement on a broad spectrum of derivative end users.

Chatham is supportive of the FASB's desire to simplify the accounting for hedging activities, resolve certain practice issues, and improve the financial reporting of hedging activities for users of financial statements. We appreciate the FASB's efforts to address concerns of both users and preparers and believe that many of the proposed changes would represent an improvement to the hedge accounting model. However, **as currently drafted, we do not believe that the proposed Statement meets the stated objectives**. Rather, based on our experience in this area and significant testing of the proposed provisions, we believe that some of the proposed changes will actually increase the overall complexity of hedge accounting, fail to be operational for many common and straightforward hedging strategies, provide inconsistent and difficult to understand financial results, increase costs that are not commensurate with the perceived benefits, and diverge from international standards and IAS 39 rather than taking a step toward convergence.

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Our primary concern with the proposed Statement relates to the elimination of the bedrock "bifurcation-by-risk" model (except in the very limited circumstances provided for in the Exposure Draft). For the reasons discussed in our letter and as illustrated via our examples, we fear that such a change will not result in an operational hedge accounting model. Rather, **we strongly agree with the "Alternative Views" provided in paragraphs A52 to A60 of the Exposure Draft**. The issues and concerns raised in the "Alternative Views" section are very legitimate, and we sincerely hope that the entire Board will seriously consider and address those issues before proceeding with any amendment to the current hedge accounting model.

In addition, we are deeply troubled that such a fundamental and significant change is being proposed without having undergone robust field testing. Interest rate hedges are utilized extensively by companies in all industries and represent the most common type of hedge in practice, and such hedges are likely to be most impacted by the proposed guidance. Accordingly, we urge the Board to thoroughly test the provisions of the Exposure Draft across a variety of market-based scenarios before a final Statement is issued. We have performed significant analysis with our client base over the past few weeks, and the following is a summary of what we learned through our testing:

- Without the ability to hedge individual risks, such as interest rate risk, **entities without very stable credit spreads will generally fail hedge accounting for hedges of overall changes in fair value or overall changes in cash flows**.
- Many (perhaps most) of our clients will be unable to qualify for hedge accounting for some of their most common hedging strategies, including:
  - Hedges of forecasted debt issuances;
  - Hedges of many fixed-rate assets; and
  - Hedges put in place after the inception of the debt (commonly referred to as "late hedges").
- Even when entities qualify for hedge accounting, significant earnings volatility will result (except for situations in which hedging the benchmark interest rate is permissible because the debt was hedged at inception).
- Hedges of short-term debt issuances (rolls of commercial paper or discount notes, etc.) and hedges of pools of assets or liabilities will be negatively impacted as well (more difficulty in qualifying for hedge accounting, significantly increased complexity, and increased earnings volatility).

Our initial testing of the provisions of the Exposure Draft included analysis of both overall changes in cash flows of a hedge of a forecasted debt issuance and overall changes in fair value of a hedge of fixed-rate debt for a high credit quality borrower with relatively stable credit spreads and a lower credit quality borrower with less stable credit spreads. Detailed results of that testing are available in Appendix B. In addition, to remove any perceived bias from our analysis, we used a random number generator based on a population of all of our public clients (for which credit information is available via a large credit data provider) and then randomly selected 30 of our clients to test over the last 12-month period. **Our results indicated that <u>only 10 out of the 30 companies would have qualified</u> for a hedge of overall changes in cash flows for a hedge of a forecasted debt issuance over that period using regression analysis.**

Surprisingly, only 1 out of 30 would have qualified over the last 12-month period using cumulative dollar offset. Furthermore, these results were based on a lower standard of "reasonably effective" rather than the current standard of "highly effective" (we considered an R-squared of only 0.5 and a slope of only -0.5 to -2.0 to be a passing grade for regression analysis [and a range of only 50% to 200% to be acceptable for dollar offset]).

Not surprisingly, our analysis confirmed that interest rate swaps do a great job of hedging interest rate risk (for example, for hedges of interest rate risk only, every single hedging relationship qualified as "highly effective" over that same period), but are completely ineffective at hedging credit risk. So, **if credit is an important driver in the overall changes in cash flows or fair value (and it frequently is), the hedging relationships will generally fail hedge accounting—even using a "reasonably effective" standard.** This is particularly true in credit environments like the marketplace is currently experiencing. Certainly the results of hedges of overall changes in cash flows or overall changes in fair value will be better in more stable credit environments, but we expect that significant failures will occur in most credit environments and that massive failures will occur in credit environments like we are presently experiencing. Paragraph A56 of the Exposure Draft makes this point very well, noting that "an interest rate swap may be designed to be extremely effective at offsetting changes in fair value or cash flows of a hedged item or transaction due to changes in interest rates, but it is probably very ineffective (and perhaps not even negatively correlated) at offsetting changes in fair value or cash flows due to changes in credit risk." That paragraph also accurately notes that a hedging relationship's qualification for hedge accounting largely will be dependent on whether changes in interest rates or changes in credit risk drive the overall changes in fair value or cash flows. We concur with those statements and would note from experience that credit very often tends to be a very significant driver of changes in fair value and/or cash flows, such that many common and straightforward hedging relationships will not qualify for hedge accounting under any reasonable interpretation of "effective."

As noted above, the attached Appendix B contains the results of some of our testing, including detailed and summarized results based on actual companies and actual market data. It includes both cash flow hedging relationships and fair value hedging relationships under different scenarios, and we would be pleased to share any additional information about our testing, valuation models, processes, data inputs, and assumptions with the Board and staff. If the Board so desires, **we also volunteer to participate in any field testing that the Board deems appropriate, and welcome the opportunity to share our insights and detailed results, have our assumptions challenged, provide analysis on new or different data sets, etc.** We feel strongly that meaningful and robust field testing is critical, given the far-reaching implications of such a fundamental change to the hedge accounting model.

Another point of emphasis is that, in our opinion and experience, combining an interest rate derivative with a credit derivative (designed to hedge an entity's own credit risk) is simply not a reasonable or viable alternative. First and foremost, we note that doing so is not consistent with how the vast majority of companies manage their risks. Companies are generally not interested in or attempting to hedge their own credit risk. Paragraph A57 of the Exposure Draft discusses some of the troubling aspects of such hedges, and our clients are rightfully concerned about the

legal implications and reputational risks associated with hedging one's own credit risk. In addition, based on our experience transacting thousands of derivative transactions for our clients, we doubt that any liquid market for hedging an entity's own credit risk could develop for the majority of our client base that would not be unduly cost prohibitive.

Finally, it is important to note that many entities do not have any publicly available credit information, and we are concerned about the use of unreliable and unobservable credit inputs to the valuation models that will materially impact an entity's results of operations. Based on our knowledge of the credit markets, we feel certain that many of the theoretical inputs to the valuation models would be based on mere "guesstimates". We do not believe that such information is useful to users of financial statements, as it lacks **reliability** and **representational faithfulness**. Furthermore, forcing credit into the equation creates difficulties in comparing Company A with Company B (how does the effectiveness of their respective abilities in managing interest rate risk really compare?) and it causes inconsistencies within an entity with respect to items that are hedged vs. items that are not hedged. Again, we concur with the views expressed in paragraph A57 of the Exposure Draft that "the key point to emphasize under the proposed Statement is that during the period that the derivative is outstanding, the entity would take hypothetical marks to earnings based on what it *thinks* the changes in their spread above LIBOR (or another benchmark) will be when the debt is issued. Those board members believe this proposed requirement is not operational, and it is not an improvement in financial reporting." (emphasis added)

Given these significant and very legitimate concerns about the proposed Statement, we would recommend either:

1) modifying the Exposure Draft to retain the current bifurcation-by-risk model (by continuing to permit the hedging of individual risks, particularly interest rate risk, we believe most of the other provisions would be operational); or

2) dropping the current project and waiting for the systematic adoption of IFRS (from our perspective, many of the implementation questions surrounding Statement 133 have been resolved over the past decade, such that urgent and sweeping changes are unnecessary at this time; this would also resolve the issue of forcing entities to implement an entirely new hedge accounting model in 2009, only to have to adopt the international model, which is also being reconsidered, in the relatively near future); or

3) adopting the derivatives and hedging provisions of IAS 39 into U.S. GAAP now.

We would support any of the three alternatives noted above and believe all would be a significant improvement over the provisions of the Exposure Draft.

Our responses to the individual questions included in the Exposure Draft's Notice for Recipients are included in Appendix A attached.

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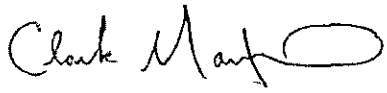
We thank the Board for its consideration of our recommendations and would be pleased to discuss these issues in more detail with the Board or staff at your convenience. Please do not hesitate to contact me at (484) 731-0235 or at cmaxwell@chathamfinancial.com.

Sincerely,



Clark Maxwell
Director of Accounting Policy
Chatham Financial

Appendix A

Comments on Specific Issues Posed by the FASB

Hedged Risk

Issue 1

For the reasons stated in paragraph A16 of this proposed Statement, the Board decided to eliminate (with two exceptions) the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. As a result of that change, the financial statements would reflect information about the risks in the hedged item or transaction that an entity both chooses to manage and not to manage as part of a particular hedging relationship.

Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?

As explained in detail in our cover letter, we strongly oppose the elimination of an entity's ability to designate and hedge individual risks. In our opinion, this will clearly impair the usefulness of financial statements and result in a hedge accounting model that is unworkable in practice. We believe that the elimination of the bedrock bifurcation-by-risk model will actually increase the overall complexity of hedge accounting, fail to be operational for many common and straightforward hedging strategies, provide inconsistent and difficult to understand financial results, increase costs that are not commensurate with the perceived benefits, and diverge from international standards and IAS 39 rather than taking a step toward convergence.

Detailed support for our position is provided in the cover letter and via the numerical examples in Appendix B.

Issue 2

For the reasons stated in paragraphs A18–A20, the Board decided to continue to permit an entity the ability to designate the following individual risks as the hedged risk in a fair value or cash flow hedge: (a) interest rate risk related to its own issued debt (that is, its liability for funds borrowed), if hedged at inception, and (b) foreign currency exchange risk. For those two exceptions, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship.

Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?

We believe that the Board should continue to permit an entity to designate interest rate risk related to its own debt (if hedged at inception) or foreign currency exchange risk as the hedged risk in a designated hedging relationship. However, consistent with our response to Issue 1 described above, we consider the current bifurcation-by-risk model to be fundamental to an entity's ability to effectively manage its risk. Accordingly, we recommend that the Board

continue to allow an entity to designate as a hedged risk not only the individual risks detailed above, but all of the individual risks currently permitted under the existing bifurcation-by-risk model (i.e., interest rate risk, foreign currency exchange risk, credit risk, and market price risk).

Hedge Effectiveness

Issue 3

This proposed Statement would eliminate the shortcut method and critical terms matching. Therefore, an entity would no longer have the ability upon compliance with strict criteria to assume a hedging relationship is highly effective and recognize no ineffectiveness in earnings during the term of the hedge. As a result, when accounting for the hedging relationship, an entity would be required, in all cases, to independently determine the changes in fair value of the hedged item for fair value hedges and the present value of the cumulative change in expected future cash flows on the hedged transaction.

Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships?

Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?

In our role as a hedging advisor, we have spent a tremendous amount time and resources in developing models to appropriately measure ineffectiveness for both fair value and cash flow hedging relationships under various long-haul methodologies. In our experience, the application of long-haul methodologies can be extremely complicated, particularly as it relates to fair value hedges, and it often requires the development of sophisticated models (we would also note that some diversity in practice continues to exist with respect to certain complicated aspects of long-haul hedge accounting). Under the proposed guidance (with limited exceptions), the complexity of these calculations will only be compounded, as credit is often exceptionally difficult to model and credit data is frequently difficult to obtain. Consequently, we foresee considerable operational constraints in calculating ineffectiveness, not only for entities that have historically applied shortcut or critical terms matching methods, but also for entities that have historically measured ineffectiveness under a long-haul method, as many of the hedging strategies employed by these entities will not qualify for one of the exceptions under the proposed standard to hedge interest rate risk only.

For the reasons described above, shortcut and critical terms matching methods are important to many end users of derivatives (although rarely utilized by our client base) that do not have access to or the resources internally to develop the sophisticated models necessary to appropriately apply a long-haul method. Moreover, we believe that many of the operational concerns related to these methods have been resolved in practice over the last few years. That said, recognizing the restatement issues over the past few years and user concerns related to the shortcut method

and critical terms matching methods, we would not be opposed to eliminating such approaches so long as the ability to bifurcate-by-risk is retained.

We believe this would be a reasonable compromise solution (eliminate the shortcut method and critical term matching, but retain bifurcation-by-risk). In other words, although the overall complexity of measuring hedge ineffectiveness would be increased, it would not be increased by an unreasonable or extreme amount, since interest rate information and interest rate models are at least reasonably well understood and widely available (unlike credit models and credit data).

Issue 4

This proposed Statement would modify the effectiveness threshold necessary for applying hedge accounting from *highly effective* to *reasonably effective* at offsetting changes in fair value or variability in cash flows.

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

For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed Statement (except for an entity's own issued debt at inception), do you believe you would continue to qualify for hedge accounting utilizing your current hedging strategy? If not, would you (a) modify your hedging strategy to incorporate other derivative instruments, (b) stop applying hedge accounting, (c) elect the fair value option for those financial instruments, or (d) adopt some other strategy for managing risk?

If the bifurcation-by-risk model is ultimately eliminated, then we would prefer a *reasonably effective* threshold for effectiveness assessments to allow for more hedging relationships to qualify for hedge accounting. However, in credit environments similar to those of the past 12 months, we do not expect that many entities will be able to qualify for hedge accounting if interest rate risk is no longer permitted to be designated as the hedged risk, so it may be a moot point for many entities. As discussed above and in Appendix B, our analysis of 30 randomly selected clients resulted in **widespread failure** of hedge accounting for hedges of overall changes in cash flows, which was entirely due to the inclusion of the credit risk component. Furthermore, these results were based on a lower standard of *reasonably effective* rather than the current standard of *highly effective*. As illustrated in our examples, including the effect of changes in credit in assessing the effectiveness of a hedging relationship designed to hedge interest rate risk will result in extensive failures of hedge accounting under **any standard of "effective"**. As such, we do not believe that modifying the effectiveness threshold, with the elimination of the bifurcation-by-risk-model, is sufficient to create an operational hedge accounting model.

We would note, however, that our preference would be to have a clearly defined standard of hedge effectiveness, whatever that may be ("highly effective" or "reasonably effective"). We believe that the benefits of clarity, consistency, and fairness in application and interpretation

outweigh any perceived disadvantages from being more "rules-based" and less "principles-based".

As for the impact of interest rate risk no longer being permitted to be designated as the hedged risk, it is difficult to assess at this point what courses of action entities may pursue. We hope that the majority of entities will prioritize the economics over the accounting results and will continue to prudently manage their risks. Many entities may not be able to qualify for hedge accounting, though, and we have a hard time believing that the earnings volatility (which many entities will feel strongly is not representative of the underlying economics of their operations) will not create a reluctance to engage in what may be the most prudent strategies for risk management.

Also, in response to the question above, we do think it is important to emphasize that "modifying your hedging strategy to incorporate other derivative instruments" is not a reasonable or viable alternative in many circumstances. In some cases, there are no appropriate derivative instruments available (for example, to hedge supply and demand basis risk that will exist in the marketplace on the date of a new debt issuance). In other cases, such as hedging an entity's own credit risk, there are legal, reputational, and cost barriers to such strategies (see our detailed comments related to this issue in our cover letter).

Finally, we would note that the fair value option is a very incomplete "solution" and is not a viable alternative for many of the most common hedging strategies in practice. We support the fair value option, and it is utilized as a substitute for some fair value hedging strategies; however, approximately 80% of the total number of hedges and almost 90% of the total notional amount hedged by our client base are cash flow hedges, which generally are not benefitted by the fair value option. Accordingly, very few of our clients have elected the fair value option to any significant degree, nor do they view it as a solution going forward (for example, the fair value option is not a solution for a hedge of a forecasted debt issuance). As such, we hope that it is widely understood that the fair value option is only a partial solution, and although it may be a potential substitute for some fair value hedges, it is not a substitute for and does not resolve the need for cash flow hedge accounting.

Issue 5

This proposed Statement always would require an effectiveness evaluation at inception of the hedging relationship. After inception of the hedging relationship, an effectiveness evaluation would be required if circumstances suggest that the hedging relationship may no longer be reasonably effective.

Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period?

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? If so, why?

We believe the ambiguity involved in determining when circumstances suggest that a hedging relationship may no longer be reasonably effective without periodically reassessing hedge effectiveness will introduce entities to more interpretation risk than under the current guidance. That said, however, for hedges of overall changes in fair value or overall changes in cash flows, we believe that the circumstances will be very rare in which a quantitative assessment will not be required. Based on our review of our clients' existing hedging strategies, along with the specific analysis we have performed and summarized in Appendix B, we believe **most hedging relationships involving overall changes in fair value or cash flows will require a quantitative assessment at inception and on an ongoing basis throughout the hedging relationship**. Additionally, we do not expect that the dollar-offset method will suffice for the quantitative assessment; rather, we believe that the quantitative assessment will need to be based upon regression analysis (or some other statistical analysis) to have any realistic hope of qualification over the life of the hedging relationship.

Issue 6

The Board considered but decided against eliminating any assessment of effectiveness after the inception of the hedging relationship. The Board believes that eliminating such an assessment of effectiveness could result in the continuation of hedge accounting even when situations suggest that the hedge relationship may no longer be reasonably effective. Some observe that an implication of the decision to not eliminate any assessment after the inception of the hedging relationship could be that hedge accounting results would be reflected in some reporting periods and not in other reporting periods throughout the life of the relationship. Also, in a hedge accounting model that generally does not permit hedging of individual risks, changes in the relationship between the individual risks being managed and those not being managed could increase the likelihood that the hedging relationship would no longer be reasonably effective. That would result in hedge accounting no longer being permitted for a portion of an expected hedge term. That "in and out" of hedge accounting would make it more difficult for users to interpret financial statements.

Do you agree with the Board's decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not 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?

We find it challenging to respond to this Issue, as our response is dependent upon whether or not the bifurcation-by-risk model is eliminated in the final standard. Bifurcation-by-risk is an essential component to any hedging strategy and allows the assessments of hedge effectiveness from an accounting perspective to closely match the underlying economics of the hedging relationship.

Under the bifurcation-by-risk model, we agree that hedge accounting should be discontinued if a hedge becomes ineffective, as the derivative instrument would have ceased to effectively hedge the risk it was intended to hedge. On the contrary, if the assessment of hedge effectiveness includes the affect of risk(s) for which the derivative was not intended to hedge, we do not

believe that ongoing assessments should be required. Such assessments would only increase the likelihood that the hedging relationship would not qualify for hedge accounting, as the hedge would likely be effective at hedging the risk it was intended to hedge and be completely ineffective at hedging the risk(s) it was not intended to hedge. The outcome of these assessments will be misleading to users of financial statements, as hedge accounting results would be reflected in some reporting periods and not in others.

Presentation of Hedging Gains and Losses

Issue 7

In the statement of operations, Statement 133 does not prescribe the presentation of gains and losses associated with hedging instruments, including the effective portion, the ineffective portion, and any amounts excluded from the evaluation of effectiveness, such as forward points. Some have suggested that such a prescription would improve financial reporting by creating consistency in the presentation of these amounts across all entities. Others observe that FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, requires disclosure about that information, and they question whether a prescriptive approach is appropriate given the diverse hedge accounting strategies employed by entities.

Do you believe that Statement 133 should be amended to prescribe the presentation of these amounts? For example, the Statement could require that the effective portion of derivatives hedging the interest rate risk in issued debt be classified within interest expense and that the ineffective portion and any amounts excluded from the evaluation of effectiveness be presented within other income or loss.

From the perspective of a financial statement user, we can appreciate the value of consistency among reporting entities with regards to the presentation of gains and losses associated with hedging instruments and, accordingly, are not opposed to a prescriptive approach. Practically speaking, however, the use of derivative instruments is so varied across industries and specific entities that consistency will be difficult to achieve without potentially compromising the usefulness of the reporting presentation for some entities. In addition, we believe that FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, which requires detailed disclosure of the amounts and location of hedging gains and losses, is sufficient to meet the needs of users of financial statements with respect to presentation.

Effective Date and Transition

Issue 8

The Board's goal is to issue a final Statement by December 31, 2008. The proposed Statement would require application of the amended hedging requirements for financial statements issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years.

Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?

Given the magnitude of the proposed changes to current practice, we do not believe the amount of time provided to adopt the proposed standard is adequate. The elimination of both the shortcut and critical terms matching methods—which requires a transition to a long-haul method—is a significant conversion for many of the Board's constituents who have not historically applied a long-haul method in assessing effectiveness and measuring ineffectiveness. This transition, when combined with the incredible effort that will be necessary to develop systems capable of modeling and measuring credit risk (which we find to be much more challenging to obtain and model than interest rate information), will require a tremendous amount of time and resources for many entities. As such, if the final standard is issued in its current form, we strongly recommend that the Board consider a significantly longer period of time for entities to effectively transition to the amended hedging requirements. In our opinion, anything less than one year would be extremely unfair to preparers.

Issue 9

The Board did not prescribe any specific transition disclosures upon the adoption of this Statement.

Do you believe that there are specific disclosures that should be required during transition? If so, what? Please be specific as to how any suggested disclosures would be used.

We agree with the Board's decision not to prescribe any specific transition disclosures. However, we would appreciate greater clarification in the final standard regarding the transition provisions. For example, would hedges of forecasted debt issuances initiated prior to transition be "grandfathered" and qualify as a hedge of the benchmark interest rate?

Also, we think it is important to note that for all cash flow hedges that are required to be dedesignated and designated anew upon transition, the derivative hedging instrument will be off-market at the inception of the new hedging relationship. From our significant practical experience in this area, we would note that such off-market cash flow hedging relationships are very complicated to model and appropriately account for in practice. The Board may wish to clarify how the transition will work in such cases, as even hedges that previously were perfectly effective and simple to account for may become extremely complicated and will likely result in earnings volatility due to what many would argue is "artificial" ineffectiveness (a forced redesignation that takes a previously "at-market" hedging relationship and creates an "off-market" hedging relationship).

Issue 10

The Board decided to permit an entity a one-time fair value option election under FASB Statements No. 156, Accounting for Servicing of Financial Assets, and No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, for (a) servicing assets and servicing liabilities designated as a hedged item on the date immediately preceding initial application and (b) eligible financial instruments designated as a hedged item on the date immediately preceding initial application of this proposed Statement.

Do you agree with the Board's decision to allow a one-time fair value option at the initial adoption of this proposed Statement? Do you agree with the Board's decision to limit the option to assets and liabilities that are currently designated as hedged items under Statement 133?

We agree with the Board's decision to allow a one-time fair value option election at the initial adoption of the proposed standard; however, we disagree with the Board's decision to limit the option to assets and liabilities currently designated as hedged items. Because the entire foundation of the hedging model is being amended (that is, bifurcation-by-risk is largely being eliminated), many entities will need to rethink their entire portfolio of hedging relationships and hedging strategies.

Benefit-Cost Considerations

Issue 11

The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The benefit-cost considerations considered by the Board are provided in paragraphs A43–A50 in Appendix B of this proposed Statement.

Do you believe the Board identified the appropriate benefits and costs related to this proposed Statement? If not, what additional benefits or costs should the Board consider?

As currently drafted, we do not think the perceived benefits of the proposed Statement justify the costs. We disagree that a simplified hedge accounting model has been achieved or that financial reporting has been improved, as discussed at length in our comments. We are also concerned by what we believe will be an explosive increase in the number of implementation issues and interpretation questions, at a time when most hedge accounting issues have finally been resolved and there is general agreement on most questions among preparers, auditors, and regulators.

From our perspective, the FASB has significantly underestimated the cost in both time and resources that compliance with a "fair value approach" to hedge accounting will require, particularly with respect to the challenges associated with developing and implementing internal long-haul models to comply with the provisions of the Exposure Draft. Paragraph A46 indicates that "Based on input from constituents, the Board believes that the incremental costs of implementing the hedge accounting approach required by this proposed Statement would not be significant." We were quite surprised by that statement, as it is very inconsistent with our own direct experience developing and implementing internal models, such as would be required to comply with the provisions of the proposed Statement, and inconsistent with all discussions we have had with preparers that will be impacted by the significant changes being proposed.

As mentioned above, we are hopeful that the Board will undertake additional study of the impact of the proposed changes, and we would be happy to assist with any analysis the Board may deem appropriate.

Appendix B

Examples Illustrating the Application of the proposed Statement to Cash Flow Hedges

Example 1A - Cash Flow Hedge of Forecasted Fixed-Rate Debt for Issuer with High/Relatively Stable Credit

Description: This example shows the results of a **cash flow hedge of a forecasted fixed-rate debt issuance**. The debt expected to be issued is $100mm, 10-year fixed-rate debt, and the hedging instrument, a swap, has terms to match the forecasted debt issuance and is forward starting one year. This example assumes that the borrower is a **high credit quality issuer with relatively stable credit spreads**. Valuation of hedged item was performed using publicly available credit default swap data.

Terms	Swap	Hedged Transactions
Notional/Principal	100,000,000	100,000,000
Start Date	6/30/2007	6/30/2007
Effective Date	6/30/2008	6/30/2008
Maturity Date	6/30/2018	6/30/2018
Fixed Leg	5.69%	N/A
Floating Leg	LIBOR	N/A

Regression Results		
R-Squared	0.77	PASS
Slope	-0.92	PASS
F-Stat	95.40	PASS

Results

				Hedged Forecasted Transactions			(Gain) / Loss				
Measurement Date	Swap Fair Value	Change in Fair Value of Swap	Cumulative Change in CFs of Hedged Transaction	Changes due to Interest Rates	Change due to Credit	Overall Changes in Cash Flow	Dollar Amount of Ineffectiveness	Credit Spread (bps)	Change in Credit Spread	Pd to Pd $ Offset %	Pass / Fail (-50% to -200%)
6/30/07	0	-----	0	-----	-----	-----	-----	22	-----	-----	-----
7/31/07	(1,282,544)	(1,282,544)	(237,777)	1,282,544	(1,520,321)	(237,777)	1,520,321	43	21	539%	Fail
8/31/07	(3,404,730)	(2,122,186)	1,794,584	2,122,186	(89,824)	2,032,361	89,824	44	1	-104%	Pass
9/30/07	(3,482,389)	(77,659)	2,415,256	77,659	543,012	620,671	(543,012)	37	(7)	-13%	Fail
10/31/07	(4,402,419)	(920,030)	2,977,570	920,030	(357,715)	562,314	357,715	41	5	-164%	Pass
11/30/07	(8,678,398)	(4,275,980)	5,773,454	4,275,980	(1,480,096)	2,795,884	1,480,096	60	19	-153%	Pass
12/31/07	(8,019,340)	659,058	5,753,273	(659,058)	638,877	(20,181)	(638,877)	52	(8)	-3266%	Fail
1/31/08	(11,129,926)	(3,110,586)	7,599,890	3,110,586	(1,263,968)	1,846,617	1,263,968	67	16	-168%	Pass
2/29/08	(11,501,855)	(371,930)	5,620,859	371,930	(2,350,961)	(1,979,031)	2,350,961	96	29	19%	Fail
3/31/08	(13,000,557)	(1,498,701)	8,156,076	1,498,701	1,036,516	2,535,217	(1,036,516)	84	(13)	-59%	Pass
4/30/08	(10,719,547)	2,281,010	7,074,400	(2,281,010)	1,199,335	(1,081,676)	(1,199,335)	69	(15)	-211%	Fail
5/31/08	(8,015,310)	2,704,237	3,670,410	(2,704,237)	(699,754)	(3,403,991)	699,754	78	9	-79%	Pass
6/30/08	(8,503,382)	(488,072)	1,535,162	488,072	(2,623,319)	(2,135,247)	2,623,319	110	33	23%	Fail
							6,968,219				

Conclusion: Regression statistics and dollar offset results are significantly worse than for a hedge of interest rates only. Depending on the interpretation of "reasonably effective," this hedging relationship may qualify for hedge accounting (regression results look OK but dollar offset % is poor in several periods). P/L volatility for "unhedged" risks is significant -- a loss of $7.0 million in 12 months.

Appendix B

Examples Illustrating the Application of the proposed Statement to Cash Flow Hedges

Example 1B - Cash Flow Hedge of Forecasted Fixed-Rate Debt for Issuer with Low/Relatively Unstable Credit

Description: This example shows the results of a **cash flow hedge of a forecasted fixed-rate debt issuance** (it is the same hedging relationship as example 1A, but for a borrower of lower credit quality and less stable credit spreads). The debt expected to be issued is $100mm. 10-year fixed-rate debt, and the hedging instrument, a swap, has terms to match the forecasted debt issuance and is forward starting one year. This example assumes that the borrower is a **lower credit quality issuer with relatively unstable credit spreads**. Valuation of hedged item was performed using publicly available credit default swap data.

Terms	Swap	Hedged Transactions
Notional/Principal	100,000,000	100,000,000
Start Date	6/30/2007	6/30/2007
Effective Date	6/30/2008	6/30/2008
Maturity Date	6/30/2018	6/30/2018
Fixed Leg	5.69%	N/A
Floating Leg	LIBOR	N/A

Regression Results		
R-Squared	< .01	FAIL
Slope	< .01	FAIL
F-Stat	< .01	FAIL

Results

				Hedged Forecasted Transactions			(Gain) / Loss				
Measurement Date	Swap Fair Value	Change in Fair Value of Swap	Cumulative Change in CFs of Hedged Transaction	Changes due to Interest Rates	Change due to Credit	Overall Changes in Cash Flow	Dollar Amount of Ineffectiveness	Credit Spread (bps)	Change in Credit Spread	Pd to Pd $ Offset %	Pass / Fail (-50% to -200%)
6/30/07	0	-----	0	-----	-----	-----	-----	271	-----	-----	-----
7/31/07	(1,282,544)	(1,282,544)	(12,025,771)	1,282,544	(13,308,315)	(12,025,771)	13,308,315	452	181	11%	Fail
8/31/07	(3,404,730)	(2,122,186)	(3,578,449)	2,122,186	6,325,136	8,447,322	(6,325,136)	368	(85)	-25%	Fail
9/30/07	(3,482,389)	(77,659)	5,210,028	77,659	8,710,818	8,788,477	(8,710,818)	252	(116)	-1%	Fail
10/31/07	(4,402,419)	(920,030)	5,612,512	920,030	(517,545)	402,484	517,545	259	7	-229%	Fail
11/30/07	(8,678,398)	(4,275,980)	1,110,263	4,275,980	(8,778,229)	(4,502,249)	8,778,229	370	112	95%	Fail
12/31/07	(8,019,340)	659,058	6,153,773	(659,058)	5,702,568	5,043,510	(5,702,568)	298	(72)	13%	Fail
1/31/08	(11,129,926)	(3,110,586)	3,678,434	3,110,586	(5,585,925)	(2,475,339)	5,585,925	367	69	126%	Fail
2/29/08	(11,501,855)	(371,930)	(758,420)	371,930	(4,808,784)	(4,436,854)	4,808,784	425	59	8%	Fail
3/31/08	(13,000,557)	(1,498,701)	(2,493,648)	1,498,701	(3,233,929)	(1,735,228)	3,233,929	464	39	86%	Fail
4/30/08	(10,719,547)	2,281,010	7,789,799	(2,281,010)	12,564,457	10,283,447	(12,564,457)	310	(154)	22%	Fail
5/31/08	(8,015,310)	2,704,237	7,498,506	(2,704,237)	2,412,944	(291,293)	(2,412,944)	280	(30)	-928%	Fail
6/30/08	(8,503,382)	(488,072)	(8,560,511)	488,072	(16,547,090)	(16,059,018)	16,547,090	485	205	3%	Fail
							17,063,893				

Conclusion: Regression statistics and dollar offset results show little to no negative correlation (positive correlation in several cases) and do not resemble the results that would occur in a hedge of interest rate risk only. **This hedge would not qualify under any reasonable interpretation of "reasonably effective."** P/L volatility for "unhedged" risks is extreme -- a loss of $17.1 million in 12 months (assuming the hedge would have qualified for hedge accounting).

Appendix B

Examples Illustrating the Application of the Proposed Statement to Fair Value Hedges

Example 2A - Fair Value Hedge of Fixed-Rate Debt for Issuer with High/Relatively Stable Credit

Description: This example shows the results of a **fair value hedge of a fixed-rate debt**. The debt principal is $100mm, 10-year fixed-rate debt, and the hedging instrument, a swap, has terms to match the debt This example assumes that the borrower is a **high credit quality issuer with relatively stable credit spreads**. Valuation of hedged item was performed using publicly available credit default swap data.

Terms	Swap	Loan
Notional/Principal	100,000,000	100,000,000
Start Date	12/31/2005	12/31/2005
Maturity Date	12/31/2015	12/31/2015
Fixed Rate	4.91%	5.16%
Credit Spread	N/A	0.25%

Regression Results		
R-Squared	0.80	PASS
Slope	-0.97	PASS
F-Stat	119.44	PASS

Results

				Changes in FV of Debt			(Gain) / Loss				
Measurment Date	Swap Fair Value	Change in Fair Value of Swap	Debt Fair Value	Change in Fair Value of Debt due to Rates	Change in Fair Value of Debt due to Credit	Overall Change in FV of Debt	Dollar Amount of Ineffectiveness	Credit Spread (bps)	Change in Credit Spread	Pd to Pd S Offset %	Pass / Fail (-50% to -200%)
12/31/05	0	-----	(100,000,000)	-----	-----	-----	-----	25	-----	-----	-----
3/31/06	(3,391,304)	(3,391,304)	(96,802,554)	3,288,677	(91,231)	3,197,446	193,858	24	(1)	-106%	Pass
6/30/06	(5,698,920)	(2,307,617)	(94,733,800)	2,279,773	(211,018)	2,068,755	238,862	21	(3)	-112%	Pass
9/30/06	(1,620,385)	4,078,535	(98,975,467)	(4,018,247)	(223,420)	(4,241,667)	163,132	18	(3)	-96%	Pass
12/31/06	(1,595,266)	25,119	(99,112,084)	(25,668)	(110,949)	(136,617)	111,499	16	(2)	-18%	Fail
3/31/07	(1,377,571)	217,695	(98,983,463)	(219,359)	347,980	128,621	(346,316)	21	5	169%	Fail
6/30/07	(4,626,388)	(3,248,817)	(95,697,078)	3,227,700	58,685	3,286,385	(37,568)	22	1	-99%	Pass
9/30/07	(1,177,222)	3,449,166	(98,164,745)	(3,423,347)	955,680	(2,467,666)	(981,499)	37	15	-140%	Pass
12/31/07	2,842,718	4,019,940	(101,071,440)	(3,944,620)	1,037,925	(2,906,696)	(1,113,244)	52	15	-138%	Pass
3/31/08	7,581,516	4,738,798	(103,595,685)	(4,718,423)	2,194,179	(2,524,244)	(2,214,554)	84	32	-188%	Pass
6/30/08	2,749,563	(4,831,952)	(97,525,003)	4,797,199	1,273,483	6,070,682	(1,238,729)	110	27	-80%	Pass
							(5,224,560)				

Conclusion: Regression statistics and dollar offset results are significantly worse than for a hedge of interest rates only. Depending on the interpretation of "reasonably effective," this hedging relationship may qualify for hedge accounting (regression results look OK but dollar offset % is poor in several periods). P/L volatility for "unhedged" risks is significant -- a gain of $5.2 million over the period.

Appendix B

Examples Illustrating the Application of the Proposed Statement to Fair Value Hedges

Example 2B - Fair Value Hedge of Fixed-Rate Debt for Issuer with Low/Relatively Unstable Credit

Description: This example shows the results of a **fair value hedge of fixed-rate debt**. The debt principal is $100mm, 10-year fixed-rate debt, and the hedging instrument, a swap, has terms to match the debt. This example assumes that the borrower is a **lower credit quality issuer with relatively unstable credit spreads**. Valuation of hedged item was performed using publicly available credit default swap data.

Terms	Swap	Loan
Notional/Principal	100,000,000	100,000,000
Start Date	12/31/2005	12/31/2005
Maturity Date	12/31/2015	12/31/2015
Fixed Rate	4.91%	6.83%
Credit Spread	N/A	1.93%

Regression Results		
R-Squared	0.00	**FAIL**
Slope	-0.02	**FAIL**
F-Stat	0.05	**FAIL**

Results

				Changes in FV of Debt			(Gain) / Loss				
Measurment Date	Swap Fair Value	Change in Fair Value of Swap	Debt Fair Value	Change in Fair Value of Debt due to Rates	Change in Fair Value of Debt due to Credit	Overall Change in FV of Debt	Dollar Amount of Ineffectiveness	Credit Spread (bps)	Change in Credit Spread	Pd to Pd $ Offset %	Pass / Fail (-50% to -200%)
12/31/05	0	-----	(100,000,000)	-----	-----	-----	-----	193	-----	-----	-----
3/31/06	(3,391,304)	(3,391,304)	(100,531,696)	2,865,255	(3,396,951)	(531,696)	3,923,000	143	(50)	638%	Fail
6/30/06	(5,698,920)	(2,307,617)	(96,168,173)	2,128,641	2,234,882	4,363,523	(2,055,906)	175	32	-53%	Pass
9/30/06	(1,620,385)	4,078,535	(99,226,384)	(3,723,483)	665,273	(3,058,210)	(1,020,325)	185	11	-133%	Pass
12/31/06	(1,595,266)	25,119	(99,303,589)	(22,115)	(55,091)	(77,206)	52,087	184	(1)	-33%	Fail
3/31/07	(1,377,571)	217,695	(99,105,894)	(194,793)	392,489	197,696	(415,391)	190	6	110%	Fail
6/30/07	(4,626,388)	(3,248,817)	(91,365,439)	3,024,256	4,716,199	7,740,455	(4,491,638)	271	81	-42%	Fail
9/30/07	(1,177,222)	3,449,166	(95,551,064)	(3,196,127)	(989,498)	(4,185,624)	736,459	252	(19)	-82%	Pass
12/31/07	2,842,718	4,019,940	(96,436,134)	(3,694,337)	2,809,266	(885,071)	(3,134,869)	298	46	-454%	Fail
3/31/08	7,581,516	4,738,798	(91,204,769)	(4,413,591)	9,644,956	5,231,366	(9,970,164)	464	166	91%	Fail
6/30/08	2,749,563	(4,831,952)	(86,925,445)	4,491,751	(212,427)	4,279,324	552,629	485	21	-113%	Pass
							(15,824,119)				

Conclusion: Regression statistics and dollar offset results show little to no negative correlation (positive correlation in several cases) and do not resemble the results that would occur in a hedge of interest rate risk only. **This hedge would not qualify for hedge accounting under any reasonable interpretation of "reasonably effective"**. P/L volatility for "unhedged" risks is extreme -- a gain of $15.8 million over the period (assuming the hedge would have qualified for hedge accounting).

Appendix B

Examples Illustrating the Application of the Proposed Statement to Fair Value Hedges

Example 2C - Fair Value Hedge of Publicly Traded Fixed-Rate Debt for Issuer with Lower/Relatively Unstable Credit

Description: This example shows the results of a **fair value hedge** of $150mm, 5-year, fixed-rate debt for one year. The hedging instrument, a swap, has terms to match the debt. **The valuation of the hedged item**, which is publicly traded, **is based on quoted market prices obtained from publicly available sources.** The borrower's credit risk has deteriorated during the past year, and its spreads have become more volatile.

Terms	Swap	Loan
Notional/Principal	150,000,000	150,000,000
Tenor	5 Year	5 Year
Fixed Rate	4.96%	5.37%
Credit Spread	N/A	0.40%

Regression Results		
R-Squared	0.08	FAIL
Slope	-0.07	FAIL
F-Stat	1.10	FAIL

Results

Measurment Date	Swap Fair Value	Change in FV of Swap	Debt Fair Value	Overall Change in FV of Debt	(Gain) / Loss Dollar Amount of Ineffectiveness	Pd to Pd $ Offset %	Pass / Fail (-50% to -200%)
Mar-07	(217,311)	-----	(149,553,000)	-----	-----	-----	-----
Apr-07	(407,381)	(190,070)	(149,883,000)	(330,000)	520,070	58%	Fail
May-07	(2,563,206)	(2,155,825)	(148,240,500)	1,642,500	513,325	-131%	Pass
Jun-07	(4,014,415)	(1,451,209)	(147,082,500)	1,158,000	293,209	-125%	Pass
Aug-07	(2,251,343)	1,763,072	(142,779,000)	4,303,500	(6,066,572)	41%	Fail
Sep-07	1,074,388	3,325,731	(143,413,500)	(634,500)	(2,691,231)	-524%	Fail
Oct-07	491,086	(583,302)	(140,826,000)	2,587,500	(2,004,198)	-23%	Fail
Nov-07	1,529,051	1,037,965	(142,348,500)	(1,522,500)	484,535	-68%	Pass
Dec-07	4,442,199	2,913,148	(127,530,000)	14,818,500	(17,731,648)	20%	Fail
Jan-08	7,625,118	3,182,919	(135,736,500)	(8,206,500)	5,023,581	-39%	Fail
Feb-08	9,352,967	1,727,849	(137,964,000)	(2,227,500)	499,651	-78%	Pass
Feb-08	10,476,782	1,123,815	(117,015,000)	20,949,000	(22,072,815)	5%	Fail
Mar-08	10,317,036	(159,746)	(115,500,000)	1,515,000	(1,355,254)	-11%	Fail
Apr-08	7,475,748	(2,841,288)	(130,500,000)	(15,000,000)	17,841,288	19%	Fail
May-08	4,705,579	(2,770,169)	(132,429,000)	(1,929,000)	4,699,169	144%	Fail
Jun-08	2,920,432	(1,785,146)	(128,250,000)	4,179,000	(2,393,854)	-43%	Fail
					(24,440,743)		

Summary: Regression statistics and dollar offset results show little to no negative correlation (positive correlation in several cases) and do not resemble the results that would occur in a hedge of interest rate risk only. **This hedge would also not qualify for hedge accounting under any reasonable interpretation of "reasonably effective".** P/L volatility for "unhedged" risks is extreme -- a gain of $24.4 million over the period (assuming the hedge would have qualified for hedge accounting).

Appendix B

Example Illustrating the Impact of the Proposed Statement on Existing Clients

Example 3 - Impact of Proposed Guidance on 30 Randomly Selected Clients

Description: In this example, we selected 30 of our public clients using a random number generator and applied the hedge accounting model proposed in the Exposure Draft to hedging relationships that would be perfectly effective under the current hedge accounting model. We calculated the effectiveness of a hedge of the overall changes in cash flows of a forecasted 5-year debt issuance. The overall changes in cash flows of the forecasted transactions were modeled using publicly available interest rate curves and implied (model-derived) credit default swap spreads from a large, well-recognized credit data provider (implied CDS was used because most of these companies do not have publicly available CDS data). The credit information and source is consistent with that used for SFAS 157 valuation purposes. We assessed the effectiveness of the hedging relationships by performing both regression analysis (we considered an R-squared of only 0.5 and a slope of only -0.5 to -2.0 to be "reasonably effective") and cumulative dollar-offset (we considered a cumulative dollar offset ratio of between 50% to 200% to be "reasonably effective").

Results: Our results indicated that 20 of the 30 randomly selected clients' hedging relationships would fail hedge accounting under the model proposed in the Exposure Draft using regression analysis. Using the cumulative dollar offset method, 29 of 30 hedging relationships would fail hedge accounting.

Conclusion: In volatile credit environments, we expect that there will be an extremely large number of companies that will be unable to qualify for hedge accounting. Based on our analysis, our observation is that hedge accounting will not be available for hedges of overall changes in fair value or overall changes in cash flows for many companies under the proposed Statement. Only entities with relatively stable credit spreads (of which there are very few in today's credit environment) are likely to qualify for hedge accounting.

Note: Due to the significant volume of data generated by this analysis, we have not included the detailed results. However, we would be happy to provide any supporting data or information upon request.