

One Wall Street, New York, N.Y. 10286

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

(Sent Via email: Director@fasb.org)



LETTER OF COMMENT NO. 5 1

Dear Board Members:

The Bank of New York Mellon, Inc. (the "Company"), a global financial institution with a balance sheet of over \$200 billion, appreciates the opportunity to comment on the Financial Accounting Standards Board's (the "FASB" or "Board") Proposed Amendment of FASB Statement No. 133 (the "Exposure Draft") which would change the accounting requirements for certain hedging activities.

While we agree with some of the proposed changes to existing hedge accounting, including the elimination of the shortcut method and critical terms matching, we do wish to express our concerns with respect to several other aspects of the Exposure Draft. Our concerns are generally in line with the alternative views expressed by the two FASB Board Members in the Exposure Draft, and we have additional concerns that we would like considered.

We are concerned that the Exposure Draft goes beyond one of its stated intentions of simplification of accounting for hedging activities, and likely will, in fact, discourage and even eliminate many tried and proven risk management strategies relied upon by corporations.

Divergence from International Accounting Standards

We also consider the timing of the proposed amendments to this Standard to be unfortunate in light of the ongoing effort toward full global adoption of International Accounting Standards in only a few years. With the IASB's project to reconsider IAS 39 in the research stages, we believe that the FASB's efforts may create confusion and complexity in the eyes of investor users. The existing Standard that has been in place for

almost 10 years could best serve users and preparers in the interim, and the Exposure Draft would introduce a period of additional divergence from IAS 39.

Scope Exception for Debt Issuances

For Banks, non-demand deposits are a significant source of funding the balance sheet. Additionally, long-dated CD's issued to institutional investors are viewed similar to long and medium-term debt when applying asset and liability management (ALM) strategy principles. We believe the Board needs to revisit the scope exception and expressly include these and similar types of liabilities. We would expect that the Board would intend "debt issuances" to be clearly defined to include all categories of term funding liabilities used by corporations, including non-demand deposit funding of a financial institution's balance sheet.

With the proviso that "debt" is intended to include such other funding in its meaning, we agree with the Board's decision to provide an exception for a company's own fixed- or variable- rate "debt" issuances and continue to permit an entity the ability to designate certain individual risks in the hedged item (e.g. interest rates) as the hedged risk in a fair value or cash flow hedge.

Hedge Effectiveness Assessment - Debt Issuances

For the purpose of determining hedge effectiveness, current practice and the proposed amendment allow the hedged debt to be marked to fair value on the basis of the interest rates alone, excluding the credit valuation component (if hedged at the debt issuance date). With the recent adoption of FAS 157 there has been an effort to include the credit value adjustment as part of the swap's value for the purpose of quantitatively measuring a hedge's effectiveness. (Although some literature and guidance suggests inclusion of the credit value adjustment in a quantitative assessment is necessary only when a qualitative assessment proves inconclusive, in practice a quantitative assessment of credit impact is almost always a required test).

This 'asymmetrical' valuation principle with respect to assessing hedge effectiveness carries forward and is memorialized in the proposed amendment. We are concerned that this asymmetry in hedge effectiveness measurement arising from the permissible marking of the underlying debt liability based on the variability of the bifurcated risk (interest rates) versus the marking of the hedging derivative based on all risks may induce ineffectiveness when indeed none exists.

DIG Issue G-10, Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative, addressed counterparty credit when assessing a hedge's effectiveness and in fact has been a considered item since universal adoption of FAS 133. It is our belief that the credit considerations pertinent to hedge effectiveness should be

binary and the credit value adjustment not be included in a quantitative effectiveness measure. The company should qualitatively assess only whether there has been any material change to the counterparty's financial position that raises doubts concerning their ability to perform their end of the derivative agreement during the forthcoming hedge assessment period.

Risk Management Concerns

Expanding on our concern regarding the consequences of measuring changes in credit of both the hedge and hedged item when assessing hedge effectiveness; we concur with dissenting Board members' views in this regard, especially as articulated in alternative view A56 "it is questionable whether an interest rate derivative would quality for fair value hedge accounting because there is no reason to expect that changes in the value of an interest rate swap would provide a reasonable degree of offset to the change in the fair value of a loan - the swap provides no protection against changes in the credit risk of the loan, which are clearly part of its fair value." Even with liberalization of the effectiveness standard from 'highly effective' to 'reasonably effective' we believe the proposed changes effectively discourage and probably will nullify the use of hedge accounting when interest rate or any other discrete risk is intended to be hedged for not only loans but also a majority of investment securities held as Available for Sale. We believe the focus of the ALM manager will be distorted through fear of unintended accounting consequences, most notably recording of the potentially significant ineffectiveness arising between the hedge and hedged items, where certain risks are not intended to be hedged.

The Exposure Draft eliminates the ability to discontinue hedge accounting without an assessment of ineffectiveness by simply removing the designation of the hedge relationship. The ability to designate and de-designate are ALM strategies currently available to the ALM manager when asset and or liability profiles change. Elimination of this provision of the existing standard could have the unintended consequence of increasing a firm's credit exposures; increasing the size of the balance sheet and negatively impacting capital ratios.

Hypothetical Example

A hypothetical example of this would be the situation where long term fixed rate debt is issued to fund a similarly termed floating rate commercial loan. The fixed rate note subjects Bank A to unwanted interest rate risk and is swapped to floating rate via an interest rate swap transaction. Many years into the transaction, the customer retires the loan early. Simultaneously, Bank A has the opportunity to lend to another customer at a fixed rate for a term matching approximately the remaining term of the fixed rate debt. The existing Statement No. 133 does not prohibit accepted ALM strategies that would have the firm dedesignate the hedge, and then redesignate it in a new hedging

relationship or by settling the swap for cash with its counterparty, and matching the fixed rate debt against the new fixed rate asset. The proposed Exposure Draft would eliminate these options, forcing Bank A to either:

- Where the swap is not terminated, issue a new fixed rate note using those
 proceeds to match-fund the new fixed rate loan and square up the portfolio of
 ALM items. This may increase the size of the balance sheet unnecessarily and
 negatively impact capital (equity to assets) ratios; or,
- Enter into a new floating to fixed swap, hedging the new asset. This may increase Bank A's overall risk exposure.

Neither alternative is as attractive as being able to dedesignate the swap and then redesignate it in a new hedging relationship, subject to a new effectiveness test being documented and passed on the date of the redesignation.

Hedging After Date of Debt Issuance

The aforementioned scope exception also provides that bifurcation of risk is not possible unless a hedge was effected upon the date of issue of the indebtedness. It's difficult to understand how the organics of issued debt can change after issue date such that the Board carved out this exception to an exception. The basic attributes salient to interest rate risk are still present. That is, size, rate and tenor. Moreover, this limitation to hedging hinders time honored and prudent asset liability management practices much in the same way as we previously discussed. This will create a barrier for the risk manager to adapt and respond to unforeseen changes in the makeup and composition of the overall balance sheet by introducing into the risk decision a new fear of unintended accounting consequences rather than a focus on prudent interest rate risk management.

We believe that the issues we have discussed extend well beyond financial institutions and many entities will be surprised that they will lose effectiveness in their accounting for suitable and prudent hedges.

Sincerely,

Ross Brown Vice President

Corporate Accounting Policy

cc John Park, Managing Director
Controller

Tony Pepenella, VP, Treasury