

August 15, 2008

Technical Director
Financial Accounting Standards Board

Re: File Reference No. 1590-100/Comments on the FAS 133R Exposure Draft

Dear Sirs:

I have read carefully the exposure draft and disagree strongly that it represents a desirable simplification of FAS 133. By eliminating bifurcation by risk, you will basically cause all constituents to reconsider their interest rate hedging strategies, because interest rate derivatives, credit derivatives, prepayment risk derivatives by singly by themselves cannot hedge the economic fair value of financial assets and liabilities. They simply cannot do it, because the most common derivatives generally hedge only one kind of risk. The comments by the Board dissenters in paragraphs A52-A60 state the issues very clearly.

Obviously, the draft reflects this concern that single risk hedging will not work very well by weakening the effectiveness standard from highly effective to reasonably effective. In other words, we know that your hedges can never be highly effective due to the elimination of bifurcated risks, so we will allow greater flexibility. In addition, you have allowed interest bifurcation hedging at inception but not late interest bifurcation hedging. There is no possible conceptual justification for that inconsistency. These two compromises shows that overall the Board feels that complete elimination of risk bifurcation hedging is a bad idea.

I understand and support the Board's intent to expand fair value reporting. But going through the back door of hedge accounting to achieve this purpose and then weakening the conceptual basis of hedge accounting by allowing only virgin interest rate hedging and reducing the highly effective hedging requirement is not the way to do it.

The right way to do it is to be honest – and better achieve your goal of financial statement comparability – by requiring all loans and receivables to be fair valued. It is just not good public policy to cause companies to possibly eliminate standard interest rate hedging because of a concern that full fair valuing of the hedged assets and liabilities will lead to unpredictable results and hedge accounting failure.

The hypothetical derivative under “cash flow hedging fair value model” is a welcome improvement, as well as the elimination of the prospective and retrospective tests. However, it is not clear to me how the ¶63.c. forward contract premium/discount exclusion can be reconciled with the hypothetical derivative for calculating ineffectiveness. If you are going to keep that exclusion, that you will need to clearly state that how the hypothetical derivative will be different from the normal case of not excluding the forward points.

This leads into the changes of option hedge accounting. Both yourselves and the IASB continue to think of options in pre-Black-Scholes terms with your obsolete time value and intrinsic value terms and requirements. No one in the market place uses these anymore.



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To require option time value to be amortized over the life of the derivative harks back to pre-FAS 133 days, and yet at the same time, you do not require amortizing of forward contract time value! Is it too much to ask the Board to be intellectually and economically consistent when it deals with derivatives?

The option time value exclusion was developed by the same people that brought you the 1998 FAS 133, Messrs. Leisenring & Smith. I've talked to them about this issue in their IASB roles, and it is clear that they do not like option hedging, question whether it is really hedging, and thus through the back door, they have used the time value exclusion to make it an unpalatable hedging technique.

They have gotten their way in the IASB, and I hope that it does not happen here. If you look at the option hedging example that the ED modifies, Example 9 of FAS 133, ¶162-164, you see what a kludge the hedging effectiveness test is. The fact of the matter that is hedging effectiveness is best done by one-sided hedging using a hypothetical option derivative as described in G20.

My final major disagreement is the ED's implicit reference to interco royalties as not affecting consolidated income and thus not eligible for hedge accounting. Interco royalties are a functional currency exposure of the principal offering the product/service/intellectual property that is sold by the affiliated company in another currency. No one would argue that a third party foreign currency royalty is not a hedgeable FX exposure of the principal. A royalty is simply another form of an intercompany sale. More so, it is something that is thoroughly examined by the local tax authorities for justification and reasonableness. Not to allow this economic exposure of the principle to be hedged is just another example of what can only be called a general antipathy to hedging in pursuit of a flawed accounting model.

I welcome the opportunity to discuss these issues further with you.

Sincerely yours,

Jeffrey B. Wallace
Managing Partner