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August 18, 2008

Technical Director- File Reference No. 1590-100 Financial Accounting Standards Board 401 Merrit 7 PO Box 5116 Norwalk, Connecticut 06856-5116



LETTER OF COMMENT NO. 109

VIA e-mail: director@fasb.org

Re: Proposed Statement of Financial Accounting Standards, Accounting for Hedging Activities, an amendment of FASB Statement No. 133.

American International Group, Inc. (AIG) is a leading international insurance and financial services organization with operations in more than 130 countries and jurisdictions. AIG companies serve commercial, institutional, and individual customers through extensive worldwide property-casualty and life insurance networks. AIG companies also are leading providers of retirement services, financial services, and asset management around the world.

AIG appreciates the opportunity to offer our most significant comments on Proposed Statement of Financial Accounting Standards, Accounting for Hedging Activities, an amendment of FASB Statement No. 133 (Exposure Draft or ED) below. In addition, we respond to the specific questions raised in the Exposure Draft in the attached appendix.

We support the Board's efforts to simplify U.S. generally accepted accounting principles. We also support the Board's broader goal of convergence with International Financial Reporting Standards (IFRS). As such, we are concerned about significantly changing the approach to accounting in the complex area of hedging activities as it would, in most cases, result in further divergence from IFRS at a time when convergence should be a priority. We note that the International Accounting Standards Board (IASB) itself is assessing the need to revise hedge accounting requirements as part of its current discussion on "Reducing Complexity in Financial Instruments." Rule changes resulting from this process could replace or even eliminate present hedge accounting provisions under IFRS. Adopting the proposal, as drafted, shortly before what many expect will be a mandated date for public companies to adopt IFRS, as a comprehensive accounting system, will cause unnecessary and extensive risk management, operations, and information technology work. At a minimum, the Board should defer issuing a new standard until the IASB issues its standard, if any, on hedge accounting.

Our view with respect to changing this area of GAAP stems from preparers' experiences initially implementing SFAS No 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS 133") and our concern such experiences could be repeated considering the significant changes proposed.

Except for relatively minor improvements provided by the ED, for example, permitting hedge accounting when the hedging relationship is expected to be reasonably effective and permitting a qualitative assessment of effectiveness, we do not believe the ED effectively achieves the Board's stated goals and objectives. For these reasons and the ones highlighted more specifically below, we do not believe that the project should go forward at this time, without full consideration of the implications to IFRS.

Considering that SFAS 133 is still being interpreted ten years after its issuance, we believe it is unrealistic to expect that new hedging rules, even if deemed "simpler," will not require similar interpretations over a significant period of time. We do not believe that the changes as proposed improve financial reporting and question whether it is beneficial for financial statement users at this juncture to have to understand significantly revised significantly accounting and reporting in this area. We question the cost effectiveness for preparers to incur the expense and effort to implement complex new accounting rules when ultimate convergence with IFRS may lead to a different accounting model, or one that is not substantially changed from current practice.

For example, AIG believes the Exposure Draft will require significant changes to information and technology systems for "long-haul" hedging by eliminating the attribution of the hedging relationship to specific risks and possibly influence how business is conducted. We believe the hallmark of any high quality accounting and reporting framework should endeavor to capture and report the business performance of an entity and not otherwise overly influence its outcome. The elimination of hedging by risk attribution, except in the two circumstances allowed by the Exposure Draft, will unduly limit the ability to hedge risks that drive the fair value of the instrument being hedged, resulting in hedging relationships that would not meet even the "reasonably effective" criterion because there are no effective hedging instruments available in the market. For financial instruments, the scenario arises because interest rate swaps are generally the most effective means of hedging interest rate risk. Interest rate swaps do not require the exchange of principal and counterparties enter into them normally under standard contractual terms that reduce credit risk. As a result, they are sensitive to interest rates while being relatively insensitive to credit and other risk factors surrounding financial instruments.

To illustrate, an investor's risk management strategy may dictate that it hedge the fixed interest rate risk associated with BBB corporate securities it owns (it has evaluated the credit risk and found it acceptable) because it funds itself with a mixture of variable rate debt instruments which, due to their nature, are not hedgeable. Because the Exposure Draft does not allow risk attribution, the entity would measure at fair value (i.e., inclusive of all risks) both the hedged BBB corporate

In July 2008, the IASB issued an amendment to the basis for conclusions in IAS 39, "Eligible Hedged Items Amendment to IAS 39 Financial Instruments: Recognition and Measurement" that effectively clarifies the IASB's view with respect to the designation of individual risks for cash flow and fair value hedge accounting.

securities and the interest rate swaps. Due to the minimal credit risk component inherent in the interest rate swaps, the entity would recognize the basis difference between the changes in the fair value of the hedged BBB corporate securities and that of the interest rate swaps. If the entity entered into a credit derivative to minimize the mismatch arising from the BBB corporate securities' credit to meet the Exposure Draft's reasonably effective test, the combination of the credit and interest rate derivatives would have the economic impact of reducing, if not eliminating, the profit the entity expected to earn by holding the BBB securities. If it did not enter into the credit derivative, it is unlikely that even the "reasonably effective" threshold would be met over a period time due to the volatility in credit spreads.

Under the proposed ED, if an entity is hedging a liability at other than inception, the credit risk also creates a hedging problem. Again, it is normally the interest rate risk the risk manager is intending to hedge. A risk manager would be faced with partial hedges, which may fail the reasonably effective standard, or no hedge accounting at all. As discussed in the prior paragraph, credit spreads may be as volatile, or more so at times, than interest rates. Requiring credit risk to be recognized in the income statement as a result of the hedging of full fair value may likely inhibit prudent hedge risk management activities.

We do not believe that limiting hedge accounting for interest rate risk on an entity's own debt to the date the debt was issued is conceptually sound; we believe it is unnecessarily restrictive and does not reflect the business realities of issuing debt. As discussed by two Board members in their dissent to the ED, entering into hedge relationships after the issuance of debt is a common business practice due to changes in the interest rate environment. It is required to allow management the ability and flexibility to manage interest rate risk in response to a changing interest rate environment. As may be seen by the recent decline in short-term interest rates without an equivalent decline in long-term interest rates, the interest rate environment is not susceptible to management by even those with the power to set targeted interest rates. An enterprise needs the ability to react to unexpected and unplanned changes by having the ability to effectively hedge its debt instruments when it deems it most appropriate. We disagree with the conclusions reached that the limitation is needed to deter certain behavior. Such limitations typically do not lead to sound economic decisions or the unbiased presentation of the economic substance of a transaction.

We do not believe the Board has justified the elimination of the ability to de-designate and redesignate a hedge relationship. We believe that such actions are taken in response to an enterprise's assessment of the current risk environment and the economics of exiting a derivative contract. As can be seen by the recent dramatic changes in commodity prices, assessments of risk environments must be made on a continual basis. In addition, the costs of exiting derivative contracts will reflect such economics. Therefore, de-designation and re-designation is an appropriate method of attempting to lower the costs of effective risk management. By disallowing this procedure, the Board will force an enterprise to incur additional costs and execution risks to maintain its current risk management methodologies.

Finally, AIG also believes that, unless the provision for the hedging of designated risks is retained, the introduction of a "reasonably effective" standard for hedge effectiveness will fall significantly short of achieving the Board's goal of accounting simplification without the attendant problems of

requiring the adoption of a myriad of accounting rules. We appreciate that the Board is attempting to simplify the rules around hedge accounting. However, we believe greater flexibility should be allowed rather than a more prescriptive approach. Our view is somewhat predicated on the fact that given the ability to elect the fair value option, the prescriptive nature of hedge accounting appears to be somewhat less of a concern.

We also note that the original intent of the project was to simplify hedge accounting. We ask the Board to revisit the original purpose of this project and whether the proposed changes will create a new set of issues that practitioners will be required to address. Recent application issues have largely been eliminated from practice as companies and their auditors have addressed them through tighter controls and stricter policies around qualifying hedging relationships. The recent absence of public company restatements attributable to the accounting for derivatives and hedging activities is evidence of this fact. As is the Board, we are proponents of principles-based accounting. However, as may be seen in the number of issues presented to the Emerging Issues Task Force on a regular basis, reasonable people will disagree on interpretations of what are designed to be clear accounting directions. In this instance, the topic is hedge accounting and it has a contentious history going back to at least its formal inception in FASB Statement No. 52, Foreign Currency Translation

Thank you for the opportunity to present our views. We would be pleased to discuss our views with Board members or the FASB staff at your convenience. Please feel free to contact me at (212) 770-6463.

Very truly yours,

/s/ Mr. Anthony Valoroso Deputy Comptroller Director of Accounting Policy

cc:

Mr. David L. Herzog Senior Vice President and Comptroller

Appendix

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?

We believe that financial statement usefulness will be diminished due to the inclusion of basis differences in the hedge disclosure for other than own debt interest rate (at inception) and foreign currency exchange risk hedges. The required full fair value hedge results would include credit risk, sector spreads, and other risks an entity most likely did not desire to hedge because certain individual risks often cannot be hedged, and the reported hedge results would therefore not reflect the best possible hedging strategies from a risk management standpoint or the intended economic substance of the transaction.

For example, a loan held for investment generally is required to be held at cost and estimates of credit losses are recognized part of an allowance for loan losses. As noted also by the dissenting Board members, current hedge accounting does not cause a company to change its accounting for credit risk, which is not normally hedged. However, full fair value hedges would result in recognizing such a loss, which would be difficult to replicate in a derivative contract and result in many such hedging relationships failing to meet even the relaxed standard of reasonably effective.

We recommend that the Board reconsider the views of the dissenting Board Members and reinstate the ability to designate individual risks.

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?

Yes, the Board should continue to permit an entity to designate those individual risks as a hedged risk because of the difficulty of hedging one's own credit risk. We believe that the elimination of hedging by risk attribution will limit the ability to hedge risks that drive the pricing of the

instrument being hedged. As a result, allowable hedge relationships would in many instances not even meet the reduced standard of reasonable effectiveness because there are no effective hedging instruments. We understand that the International Swaps and Derivatives Association is providing the Board with examples of the correlation problems caused by the inability to attribute risk and is asking the Board to give due consideration to the seriousness of this problem. In brief, the problem arises for financial instruments because interest rate swaps are generally the most effective means of hedging interest rate risk. Swaps do not require the exchange of principal and they are normally executed under standard contractual terms that also reduce credit risk. As a result, they are sensitive to interest rates while being relatively insensitive to credit and other risk factors surrounding financial instruments.

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?

We have no comment.

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?

The change to a reasonably effective standard is appropriate given the overall trend to principles-based accounting because the bright lines that have developed around the highly effective standard often cause satisfactory hedge relationships to fail merely due to temporary mechanics. We do not believe that a change to the reasonably effective standard will result in an improvement to the hedge accounting model if the ability to hedge specific risks is eliminated for the reasons cited in our response to Issues 1 and 2 above.

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?

We are concerned that there are significant instances where a hedge relationship would not qualify for hedge accounting due to the inability to attribute specific risks as being hedged, e.g., the interest rate risk of loans held for investment. The specific credit risks are often not hedgeable due to lack of available market instruments for middle market commercial customers, for example. We would be forced to discontinue many of our SFAS 133 hedge accounting strategies and revert to economic hedging. We do not believe that the fair value option reflects the economics of the positions held in many cases. As noted in our cover letter, an entity often purchases or originates financial assets for the credit exposure inherent in them. The interest rate risk however may not be consistent with the risk management strategy driving an entity's funding sources. The inability to attribute risk for hedge accounting purposes will result in the financial statements containing misleading and confusing information.

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?

No, we do not believe that there will be significant operational concerns in creating such processes because the current hedge accounting standard's more rigorous requirements have been effectively met and we believe that the reasonably effective standard would be leveraged off of the same systems.

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 that it is appropriate to use a quantitative test only if a qualitative indicates that the hedge relationship may fail.

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 believe that effectiveness at inception of the hedge relationship is all that is required because ineffectiveness will be recognized through income and disclosed in the footnotes. If an entity believes that the hedging relationship would no longer remain effective, it would end the relationship by closing out the derivative to avoid the economic costs of continuing an ineffective strategy as well as to minimize the income statement volatility. The economics of the hedge relationship will drive the accounting as well as the risk management strategy.

Presentation of 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.

We do not believe that a prescriptive approach is necessary nor good financial reporting. SFAS 161 requires copious disclosures and the various hedging strategies would not benefit by being

forced to comply with limited reporting options. In addition, the SEC reporting rules require different reporting locations for income statement items for different types of companies.

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 that the proposal is introducing hedging rules that will require at least a year to interpret their full impact on an entity's hedging strategies, operations, risk management, and accounting systems, we believe that the effective date is too soon. We believe that the effective date should be delayed until no earlier than fiscal years beginning after November 15, 2010. However, to repeat our earlier comment, the Board should consider the wisdom of promulgating new standards in a complex area of accounting during this period of IFRS convergence. We do not believe this ED meets the objectives the Board has set and it should not be issued given the high potential for its very limited lifetime.

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 do not believe there are specific transition disclosures needed if the ED is adopted.

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?

There should be no restrictions given the wide-ranging changes which would become effective if the ED is adopted as written. This would be consistent with the SFAS 115 classification changes allowed for when SFAS 133 initially came into effect and when there were previous significant changes. In those instances, companies which did not have SFAS 133 accounting hedges in effect

at the time of the changes were allowed to move securities into, or out of, a securities classification without an accounting consequence.

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?

Given the magnitude and nature of the proposed amendments, we do not believe the Board has given due consideration to the changes in accounting, operations, and risk management systems that would be required to comply with a complete revamping of hedge accounting systems. In addition, the Board, in our view, has not fully considered implications of this proposed guidance with respect to IFRS convergence. The additional costs from these items far outweigh any short-lived, perceived benefits from the proposals to either users or preparers.