August 15, 2008

Mr. Russell G. 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:

RBS Greenwich Capital ("RBSGC") 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"). The vast majority of our U.S. based derivative clients apply Statement 133's hedge accounting provisions and will be subject to the requirements of the proposed Exposure Draft. We believe that we are in a position to understand the impact and ramifications of the proposed guidance on a broad spectrum of derivative end users. Though not an issue for RBSGC, we expect that most of the proposed changes, especially those around hedges of interest rate risk, will introduce significant issues to corporate companies that account for most, if not all, of their derivative hedge transactions in accordance with the shortcut method (for qualifying recognized debt) and the critical terms matching method (e.g., hedges of foreign currency risk).

We are concerned with the proposed changes and we agree with the "Alternative Views" that the Board did not achieve any of its stated objectives with respect to this project – simplify hedge accounting, improve the usefulness and understandability of financial statements, resolve major practice issues, and address recognition and measurement anomalies between hedging derivatives and the associated hedged items.
The provisions intended by the Board to simplify hedge accounting will not be permitted for most hedge strategies in practice due to the limitation of the bifurcation-by-risk hedge model and the wording in the Exposure Draft calling for quantitative assessment and periodic reassessments in "certain situations." Furthermore, the removal of the shortcut method and the critical terms matching provisions will significantly increase complexity of hedge accounting which clearly fails the Board’s objective for simplification.

We do not understand why the Board believes the Exposure Draft would improve the usefulness and understandability of financial statements when the inclusion of unhedged and unhedgeable risks will increase the asymmetry between the accounting results and the risk management results.

The proposed Exposure Draft will actually increase reported recognition and measurement anomalies between a hedging instrument and a hedged item by incorporating unhedged risks to an extent that will lead companies to significantly limit, change, or in many cases eliminate altogether some of the most simple, common, prudent, and perfectly effective (if not nearly perfectly effective from an economic perspective) hedging strategies applied in practice today. We have often seen that companies generally abandon otherwise economically prudent risk management strategies altogether when the accounting model reflects results that are unrepresentative of their hedging activities in the income statement – especially when misrepresentative earnings volatility is increased from an accounting perspective while from an economic perspective the company is effectively hedged and cash flow volatility has been mitigated or eliminated. In addition to altering, limiting, and eliminating generally accepted corporate risk management practices, we believe that the proposed new hedge accounting framework will be quite costly to implement as we expect a long period of uncertainty while the practitioners, auditors, and regulators figure out how to interpret many of the vague requirements or principles of the Exposure Draft including:

- "reasonably effective"
- "in certain situations, a quantitative assessment may be necessary"
- "only if circumstances suggest that the hedging relationship may no longer be reasonably effective"
- "settle within a reasonable time period"
- "difference is minimal"
- "demonstrate an economic relationship"
- "include identifying the sources of volatility associated with the hedged item or forecasted transaction and supporting a conclusion that the hedging instrument would be reasonably effective"

Eliminating the shortcut method, precluding benchmark interest rate hedging of forecasted debt, limiting benchmark interest rate hedging of recognized debt, and eliminating critical terms matching (including DIG Issue G20) will force U.S. "corporates" to incur tremendous costs to understand, interpret, and implement those radical changes. The costs of the Exposure Draft will be far greater when one considers the hedging strategies that will be delayed, reduced, or eliminated altogether as U.S.
companies deal with the proposed changes and await definitive interpretative guidance from their consultants, auditors, and the regulators for fear of changes of interpretations or differing interpretations, e.g., between the auditors and the regulators. Since many U.S. "corporates" do not independently measure the hedged item for any of their hedge relationships under the current requirements (i.e., shortcut and critical terms match methods), they will require new systems, processes, policies, procedures, and resources to be in a position to independently measure the hedged item, including establishing new controls over those systems, processes, policies, procedures and new resources.

As noted above, our experience in the U.S. corporate derivative market has shown us that many U.S. companies will avoid those hedging strategies for which the Exposure Draft will require distorted results to be reported to a company's stakeholders. We see this every time a large cross border transaction is announced by one of our clients and we begin discussions with them around managing the risks of currency movements on the transaction price in the home currency or managing the interest rate risks around the forecasted funding required by the transaction. Because hedging either of those risks would be reported just like speculative derivative positions rather than as risk mitigating transactions under the current hedge accounting framework, relatively few companies hedge those risks. When a company does decide to hedge those risks despite the accounting distortions, however, they usually purchase options rather than forward based derivatives so that the maximum possible reported "accounting loss" in the financial statements is bounded. We believe that should the FASB ever "permit" those and other "non-qualifying" risks to be hedged and be properly accounted for and reported as being effectively hedged, we will see an exponential increase in the number of companies that would hedge those transaction exposures.

We believe that the new hedge accounting model should address significant weaknesses in the current framework. For example, we think the Board should consider improving the current hedge accounting model to accommodate derivative hedging of currently "non-qualifying" risks including bifurcation-by-risk hedging of commodities, and foreign currency and interest rate risk related to cross border acquisitions.

We would support the FASB to undertake a joint project with the IASB to study and research various risk management practices utilized by "corporates" globally and then work together to develop an accounting model that properly reflected the economics of those hedge relationships without bias. The Alternative Views touched upon a key issue with this project and other projects for that matter - creating accounting standards that distort, misrepresent, and disconnect from the economics of the business transactions the accounting framework is established to capture and report. Standards setters should strive to establish an unbiased accounting model that produce financial statements that accurately depicted the financial aspects of the underlying business transactions whatever they may be.
We believe that this Exposure Draft will increase the number of hedge strategies where the economic hedge effectiveness reported internally to senior management, the Board of Directors, the risk manager, the CFO and others will differ from that required to be reported under U.S. GAAP to the users of a company’s financial statements - investors, the company’s banks, and the equity analysts covering the company.

We fully support the Alternative Views expressed in the Exposure Draft except for the idea of immediately converging to IAS 39. In our view that approach would otherwise appear to be a viable alternative for the Board except for the IASB’s project (see the IASB’s Discussion Paper, Reducing Complexity in Reporting Financial Instruments) to reconsider the accounting for financial instruments altogether including accounting for derivative hedging transactions. To the extent that the IASB’s project leads to an amendment or replacement of IAS 39, it would prove quite costly for U.S. companies to adopt IAS 39 in the next year or so and then undertake another transition to the IASB’s new derivative instrument accounting framework shortly thereafter. Accordingly, we believe the Board should altogether halt this project and “wait for the systematic adoption of IFRS” that is also anticipated by some of the current FASB Board members. In the meantime, the FASB could jointly develop a plan with the IASB to converge to a global hedge accounting model building on the work done by both Boards in their respective projects to date. Having been issued in 1998, Statement 133 is relatively well understood and has been vetted with the accounting firms for approximately ten years now. Further, in order to “simplify the accounting for hedging activities”, we believe the FASB would be best served to:

- Retain paragraph 68 for recognized interest bearing bond/debt hedges (or expand paragraph 65 to accommodate those hedges),
- Retain paragraph 65 for all other types of hedges (e.g. foreign currency and certain commodity cash flow hedges) including debt hedges not within the scope of paragraph 68, and
- Retain the ability to designate interest rate risk as the risk being hedged associated with forecasted transactions involving debt instruments
- Expand the bifurcation-by-risk hedge model to include other risks, e.g., commodities, and inflation.
In our experiences, those provisions of Statement 133 are applied by nearly every “corporate” company in the U.S. that:

- Swaps fixed rate debt to a floating benchmark interest rate index (6 months or shorter)
- Swaps fixed or floating rate debt denominated in a foreign currency to floating rate index denominated in the issuer’s or holder’s functional currency
- Hedges interest rate risk associated with forecasted transactions involving debt instruments
- Hedges forecasted revenues and/or expenses denominated in a foreign currency (including intercompany forecasted transactions, e.g., royalties, raw materials, parts, WIP inventory)
- Certain hedges of commodity risk associated with forecasted purchases or sales

Those strategies above comprise the bulk of U.S. “corporate” hedging activities for which companies seek to apply hedge accounting. The other prevalent types of strategies that companies apply Statement 133’s hedge accounting requirements to include:

- Swapping floating rate debt to a fixed interest rate (usually 100% effective under the long haul - dollar offset / hypothetical derivative method)
- Swapping floating rate or fixed rate foreign denominated debt to a fixed rate of interest denominated in the issuer’s or holder’s functional currency (also usually 100% effective)

We strongly recommend that the FASB retain and build on the key existing simplifying provisions already contained within Statement 133 – shortcut method and critical terms matching method. One approach to simplify hedge accounting in the near term, that would have minimal implementation cost, would be to retain the “reasonably effective” hedge effectiveness threshold proposed in the Exposure Draft and to expand the application of paragraph 65 of Statement 133 and the related DIG Issues G9 and G20.

Accountants are not risk managers and we should not establish accounting rules and principles that bias companies towards or against specific hedging strategies. All economic hedging strategies should be properly captured and reported, to the extent effective, as hedging strategies in the financial statements. We should continue to develop and improve the hedge accounting framework rather than proceed with the Exposure Draft which will increase the chasm between economic reality and financial reporting for derivative hedging transactions.
The second part of our letter addresses some of the issues/questions posed to constituents in the Exposure Draft. Due to the nature of the questions, some of the items discussed thus far are repeated in a number of our responses to those questions.

We hope you find our comments and recommendations informative and beneficial. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned.

Sincerely,

[Signature]

Gregory S. Martin
RBS Greenwich Capital
203.625.6913
Gregory.Martin@RBSGC.com
Responses to Questions in Notice for Recipients of This Exposure Draft

Hedged Risk

Issue 1/Question 1: 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 discussed in the body of our letter above, we fully support the Alternative Views and the continued development and expansion of the existing bifurcation-by-risk hedge model. Limiting the bifurcation-by-risk model as proposed will significantly increase the complexity from a preparer and interpretation standpoint which will translate directly to impairing the transparency and therefore the usefulness of the resulting financial statements.

We believe the usefulness of financial statements will be impaired as the chasm between reported results (accounting results) and economic reality (risk management results) will be drastically increased.

The resulting income statement will be very confusing and completely indecipherable for investors as “economic” ineffectiveness related to the intended hedged risk will not be distinguishable from “accounting” ineffectiveness from the unhedged or unhedgeable risks. Further, comparability for otherwise similar hedges will be impossible due to the introduction of unhedged and unhedgeable risks into the reported effectiveness. The reported results would be even more confusing if the unhedged risk were actually “hedged” elsewhere within the company without the use of a derivative, for example, via an ability to pass on that risk to a customer or vendor.

We object to an accounting framework that dictates when and what risks a company should or should not hedge, especially when some of those risks required to be hedged by the hedge accounting rules are unhedgeable. Companies may abandon otherwise prudent risk management policies and strategies when the accounting for those strategies distorts the economic effectiveness of the hedge relationship. Also, companies often decide not to hedge certain risks for many prudent financial and economic reasons. It may be uneconomical to hedge for any number of reasons, e.g., minimal volatility, prohibitively expensive hedge costs, or the risk exposure is immaterial to the overall company. It is unclear why the FASB seeks to establish prohibitive accounting provisions to force companies to hedge total risks even when a “total risk” hedge solution is not available in the derivative markets.
We support the four current Board members' (Batavik, Herz, Seidman, and Smith) public statements in the Board meetings that we listened to supporting the further development of the “bifurcation-by-risk” approach in the current Statement and we fully support those Board members that support expanding paragraph 65 and DIG Issue G9 rather than eliminating those simplifying provisions as proposed under the Exposure Draft’s “Fair Value Hedging model.”

**Issue 2/Question 2: Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?**

We do support the Boards decision to permit those individual risks as a hedged risk and we encourage the FASB to remove the limitation on designating those risks as hedged risks for only debt hedged at inception. Eliminating bifurcation-by-risk from the hedge accounting model will significantly increase interpretation/restatement risk, complexity, and cost to implement while reducing the usefulness of the financial statements.

We do not believe that the accounting for debt hedges should be biased towards hedges done at the debt’s inception as opposed to before or after inception and we do not understand the theoretical basis for why the accounting for debt hedges, and only debt hedges, should be fundamentally different depending on when a company implements its debt hedge strategy. You are either hedged or you are not hedged. There is no such thing as a “late hedge” as the interest rate swap responds to changes in the underlying in the same manner regardless of when it is executed and those changes economically offset the designated hedged risk of the underlying hedged item from the time the hedge is implemented. Further, why does the FASB continue to take issue with “late hedging” of interest rate risk only and does not take issue with “late hedging” of commodity, foreign currency, or equity risk? To the extent that the Board continues to distinguish between interest rate risk and other risks from a “late hedge” perspective, the Board should provide a thorough basis for that conclusion in the final statement.

**Hedge Effectiveness**

**Issue 3/ Question 3a: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships?**

*Measurement/Assessment of Hedge Effectiveness – Fair Value Hedges – Swap Fixed Rate Debt to Floating (at the inception of the debt)*

Despite the exception provided in the Exposure Draft that will continue to permit hedges of changes in the fair value of fixed rate debt due solely to changes in the benchmark interest rate (i.e., the LIBOR swap rate), the Exposure Draft will not simplify and may even preclude hedge accounting for these otherwise vanilla hedge relationships. That is because the Exposure Draft also eliminates the “shortcut method” for measuring the change in fair value of the fixed rate debt due solely to changes in the benchmark interest rate. The Exposure Draft will require independent measurement of the change in value of
the debt without reference to the hedging interest rate swap. When companies actually perform this measurement they will find that their dollar offset ratios will often be outside 80-125% (by many accounts at least two of every four quarterly reporting periods) and may even be below/outside 70% - 130% effective. Accordingly, despite the exception provided in the Exposure Draft for “at inception” debt hedges, I believe auditors will not permit companies to qualitatively assess these hedge relationships given the results that would be obtained if a dollar offset approach were applied. The reason for these unintuitive results is due to FAS 133’s requirement in paragraph 21(f) that a company must consider the contractual cash flows of the fixed rate debt despite that fact that the swap is only capable of offsetting changes in the benchmark swap rate component of the “all-in” coupon of the hedge debt. For more on this please see pages 8-13 from our September 2007 comment letter on Proposed DIG Issue E23 (http://www.fasb.org/ocl/fasb-getletters.php?project=ISSUE-E23) that we included as an appendix to this letter.

We recommend that the FASB amends paragraph 21(f) to change the methodology required to calculate the change in the fair value of fixed rate debt attributable to changes in the benchmark interest rate to be consistent with the qualifying, designated hedged risk. Specifically, state in paragraph 21(f) that in calculating the change in the hedged item’s fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on only the benchmark interest rate component of one or more of the designated contractual cash flows of the hedged item. This change would converge with the measurement requirements in IAS 39 for this hedge relationship, a current GAAP difference that will become significant to the extent the shortcut method is eliminated. Such a correction, would also allow for partial term hedges of fixed rate debt and hedges of callable debt to qualify for hedge accounting under the long haul method to the extent the shortcut method was not available. Without that correction, hedges of callable debt will not qualify under the ED and partial term hedges of fixed rate debt will continue to not qualify despite being allowed in theory. Both items easily qualify for hedge accounting under IAS 39. It would also result in reported hedge effectiveness for those hedge relationships that would accurately reflect the economic hedge effectiveness of the hedge relationship and would be equivalent to hedge effectiveness reported under the requirements of IAS 39. We struggle to understand the FASB’s theoretical basis for creating a hedge accounting model that leads to “accounting” hedge effectiveness being reported to users of the financial statements that materially differs from the economic hedge results reported to a company’s risk manager.

Even if the auditors and regulators allow certain or all companies to assess these hedges qualitatively at inception, the Exposure Draft will still increase a company’s cost of implementation for this particular hedge strategy due to the requirement to independently measure the change in fair value of the debt due to changes in the benchmark interest

---

1 We suggested detailed edits to Statement 133 to converge paragraph 21(f) and related text to IAS 39 in our comment letter last year on Proposed DIG Issue E23. Also in that letter, we identified other technical corrections needed to be made to Statement 133 that we believe resulted from drafting errors during the Statement 138 amendment of Statement 133.
rate. This will require a change in accounting systems and processes on at least a quarterly basis including the controls around those systems and processes (Sarbanes-Oxley 404). These implementation costs are not “one time” costs as described by the Board in paragraph A48. The costs to implement will not be one time as maintaining systems and added controls and processes as well as hiring additional people clearly require ongoing costs. We believe that the Board is severely underestimating what the costs will be.

An example of the added complexity required by the Exposure Draft for this hedge is the decision to measure the change in value of the debt over the life of the hedge relationship by discounting the debt using a flat LIBOR discount curve or the LIBOR discount curve shifted based on the initial credit spread (i.e., debt coupon – benchmark LIBOR swap rate as at the debt issue date) of the underlying hedged debt. That is just one example where companies that previously measured the hedged item and hedge effectiveness using the same method (either shortcut method or critical terms matching method) will actually have different measurement options under the Exposure Draft which directly contradicts one of the Board’s perceived benefits as described in paragraph A44(b).

The same effectiveness, measurement, and cost-to-implement issues discussed above would impact fair value hedges of foreign currency debt (e.g., swapping fixed or floating rate foreign currency debt to floating rate in the issuer’s functional currency).

**Measurement/Assessment of Hedge Effectiveness – Fair Value Hedges – Swap Fixed Rate Debt to Floating (after the inception of the debt) – AND – Swap Fixed or Floating Rate Foreign Currency Debt to Floating Rate in the Issuer’s Functional Currency (after the inception of the debt)**

It is likely that most companies will not be able to qualify for hedge accounting at all under the Exposure Draft for hedges of fixed rate debt after the debt issuance date, especially given the comments of the two dissenting Board members in their “Alternative Views” outlined in paragraphs A52 – A 60 of the Exposure Draft. The reason that it will be difficult to establish the expectation that the swap will “reasonably” offset the total change in fair value of the debt is the MTM volatility associated with the issuer’s credit spread that would be introduced by the Exposure Draft. It is easy to imagine a scenario, especially in the credit environment we have been experiencing, where the swap and the debt both experience a change in fair value in the same direction resulting in zero offset.

Accordingly, if the ED is passed as currently drafted, companies will likely be forced to hedge their debt only at inception thereby effectively forcing companies to be more active in the debt, commercial paper and other capital markets (as opposed to derivative markets) to manage their interest expense and cash flow profile, which is inefficient and much more costly and will put U.S. companies at a competitive disadvantage from a financing and interest rate risk management perspective. As described in the section above, depending on how “reasonably effective” is defined, even “at inception” debt hedges may not qualify for hedge accounting due to the requirements in paragraph 21(f) requiring measurement of the hedged item that contradicts the benchmark interest rate
risk designation. We explain the perceived “flaw” in paragraph 21(f) and related paragraphs in detail in Appendix A.

In addition to the comment letters received in response to this exposure draft, the FASB should also review the comment letters they received last summer in response to proposed DIG Issue E23, specifically the comments relating to the Board’s proposal to “discriminate” against hedges of fixed rate debt after the issuance date. We think many of the points argued to the Board at that time are supportive of retaining consistent accounting for hedges of debt regardless of when the hedge is executed.

*Measurement/Assessment of Hedge Effectiveness – Cash Flow Hedges – Swap Floating Rate Debt to Fixed – AND – Swap Foreign Currency Fixed or Floating Rate Debt to Fixed Rate in the Issuer’s Functional Currency*

To the extent that these types of hedges are executed only at inception of the debt, there should not be an issue under the Exposure Draft.

For hedges executed after the inception of the debt there should not be an issue under the Exposure Draft unless the variable rate debt has credit spreads that vary based on some index or other market observation or are based on financial ratios or covenants of the issuer which is fairly common especially for lower rated companies. The reason is when you hedge after the issuance date of the debt, under the Exposure Draft a company must hedge total variability in cash flows including changes in the credit spreads which as discussed earlier could be problematic and may even preclude hedge accounting altogether even with the lower “reasonably effective” hedge effectiveness bar permitted by the Exposure Draft.

*Measurement/Assessment of Hedge Effectiveness – Cash Flow Hedges – Using Treasury Locks or Forward Starting Swaps to Hedge the Coupon Variability Associated with a Forecasted Issuance of Fixed Rate Debt – AND – Interest Rate Swaps Hedging Rolling Commercial Paper Programs*

Another vanilla and common hedge strategy that the Exposure Draft will likely eliminate from practice is referred to as pre-issuance hedging. In this strategy, the company enters into a Treasury lock or a forward starting interest rate swap to hedge the impact of increasing benchmark market interest rates on the coupon to be set on a forecasted issuance of fixed rate debt. This easily qualifies as a cash flow hedge under the current Statement 133. Under the Exposure Draft, the exception provided for hedges of debt only applies to recognized debt, so this hedge relationship under the Exposure Draft must consider total changes in the forecasted debt’s coupons including the issuing company’s own forecasted credit spread as well as the “new issue premium” (which has ranged between 60 – 100 bps in recent weeks). This requirement, if it doesn’t eliminate all such hedge relationships altogether, will cause numerous measurement issues when it comes to defining and measuring the hypothetical derivative.
We believe that benchmark interest rate hedges of rolling commercial paper programs (see paragraphs 153-161 of Statement 133 and DIG Issue G19) will no longer qualify for hedge accounting under the Exposure Draft due to the inclusion of unhedged risks, e.g., credit. Because the roll of a commercial paper issuance constitutes a forecasted issuance of debt, it would not qualify for the benchmark interest rate designated hedged risk exception.

An extremely problematic consequence of the Board’s decisions, is that the hypothetical derivative required by the Exposure Draft for those hedge relationships is a derivative that only exists in theory and requires level 3 inputs (by analogy to Statement 157) to determine its fair value, i.e., forecasted credit spreads and the “new issue premium”. So the effectiveness of the forward starting swap or the Treasury lock, both likely Level 2 valuations under FAS 157, would be determined by a made-up-hypothetical-derivative that would be classified as a Level 3 valuation if reported under Statement 157. We do not believe that requiring “accounting hedge ineffectiveness” to be reported based on level 3 inputs is an improvement in financial reporting from the investor/user perspective and a simplification from a preparer as well as user perspective. Further, it contradicts a noted benefit of the Exposure Draft prescribed by the Board in paragraph A44(b) – comparability of the measurement of hedge effectiveness.

We recommend that the Board continues to permit benchmark interest rate hedges of the forecasted issuance of debt, including rolling commercial paper programs. Not doing so will be a drastic change in practice and will be costly to U.S. companies to implement. The cost of not qualifying for hedge accounting will be driven by market interest rates. International companies will not have to deal with that cost uncertainty as they will be able to hedge under IAS 39. To the extent companies are able to somehow qualify for hedge accounting for pre-issuance hedges, the measurement approaches will not be comparable due to the incorporation of unhedgeable risks that require “Level 3” inputs to determine hedge ineffectiveness.

Measurement/Assessment of Hedge Effectiveness — Cash Flow Hedges — Hedging Forecasted Revenues and Expenses Denominated in a Currency Other than the Company’s Functional Currency Using Forward Contracts

Foreign currency hedging should benefit from one of the provisions of the Exposure Draft – the “reasonably effective” threshold.

However, we do not believe that many companies will be able to avail themselves of the simplified hedge accounting approach offered by the Exposure Draft (i.e., qualitative upfront assessment and no requirement to reassess hedge relationships periodically) unless they have perfect hedges or hedges that would have qualified for the critical terms matching method (paragraph 65) without having to perform the “de-minimus” testing required by the EITF observer’s comments at the March 2007 EITF meeting for 30-day bucketing hedges. We believe the Exposure Draft’s use of the words “in certain situations, a quantitative assessment may be necessary...” will force auditors or allow the regulators to require companies to quantitatively assess at inception and prospectively
any hedge relationship that is not absolutely “perfect”. We think the only relationships that would be considered perfect are single cash flow hedges where the hedging forward contract exactly matched the timing of that cash flow and there was no uncertainty in that timing.

To the extent we are correct, the proposed Exposure Draft will increase the costs of hedge accounting for those relationships that companies currently account for under the critical terms matching method that will be eliminated by the Exposure Draft. The Exposure Draft will require independent measurements of the hedging derivative and the hedged item even if a company “qualifies” to assess its hedge qualitatively at inception. Under critical terms and the shortcut method, the company only has to measure the derivative while assuming that the hedged item changes by the same amount - a perfectly valid assumption. Under the Exposure Draft companies will not be able to do that for any hedge relationship and that will increase the cost to implement the Exposure Draft’s proposed changes to hedge accounting with no incremental benefit to the reported financial statements. Accordingly, we do not believe that any of the perceived benefits noted by the Board in paragraph A44 will be achieved in practice by the Exposure Draft.

We believe that companies that hedge to the settlement date of the forecasted receivable or payable and dedesignate the hedge as of the recognition date of the receivable or payable will still be able to qualify for hedge accounting under the Exposure Draft however, they may have to change the way such hedge relationships are documented because of the preclusion of dedesignating hedge relationships by the Exposure Draft. We are not sure what the actual impact will be to these hedge relationships, especially for existing relationships as of the effective date (if the Exposure Draft goes through), but one possible point of contention or issue might be how the hypothetically perfect derivative should be defined for such a hedge relationship.

Paragraph 23 of the Exposure Draft provides that, “the measurement of hedge ineffectiveness shall be based on a comparison of the change in fair value of the actual derivative designated as the hedging instrument and the present value of the cumulative change in expected future cash flows on the hedged transaction. For example, an entity could compare the change in fair value of the actual derivative with the change in fair value of a derivative that would mature on the date of the forecasted transaction, be priced at market, and provide cash flows that would exactly offset the hedged cash flows.”

Requiring the use of a derivative that exactly offsets the hedged cash flows while simultaneously removing guidance that assists in the definition of the terms of the hypothetical derivative, adds significant complexity and uncertainty into the hedge accounting model. The underlined text of paragraph 23 above could be interpreted that the hypothetical derivative to be used when measuring the effectiveness of a hedge must have a cash flow settlement date/maturity that exactly matches the settlement/payment date of the hedged item. In many cases, a derivative is designed to hedge to the particular date that the hedged item is expected to be realized which usually is the date on which the actual cash flows to be paid or received are contractually fixed. Specifically, would the
hypothetical derivative have a maturity date that coincides with the maturity of the hedge relationship (i.e., the recognition date of the forecasted revenue or expense) or would the hypothetical derivative have a maturity date that matches the settlement date of the resulting receivable or payable which would match the maturity date of the actual hedging derivative? Our view is that the hypothetical derivative should have a maturity that matches the forecasted settlement date, the date the variability in the cash flow in the settlement currency is fixed.

We recommend the FASB clarify paragraph 23 to define the hypothetical derivative as a derivative with cash flows that exactly “offsets the variability of the hedged cash flows” rather than “offset the hedged cash flows” themselves.

If the FASB’s objective of its “hedge accounting simplification project” is to simplify the accounting and reporting of foreign exchange and commodity cash flow hedges then the Board should expand the application of paragraph 65 (referred to as the “critical terms matching” method) rather than eliminating it. Eliminating paragraph 65 and DIG Issues G9 and G20 will increase complexity in defining and valuing the hypothetical derivative and will cause companies to double the number of valuations that they have to do by forcing them to independently value the hypothetical derivative when they otherwise would qualify for the critical terms matching method under the current framework for these otherwise vanilla and common hedge strategies.

Issue 3/Question 3b: 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?

The usefulness of financial statements will not be improved because eliminating the shortcut method and the critical terms matching methods will increase complexity and operational burden on the preparer side that will almost by definition lead to increased complexity for the readers of the financial statements. Increasing unexplained volatility that is not related to observed economics will not be useful and will cloud the actual performance of companies and reduce the comparability of financial statements of otherwise similar companies with similar risk management policies. One of the many reasons for this is that the unhedged or unhedgeable risks are generally company specific risks which will not be comparable from company to company. The volatility of those risks on reported earnings will then cloud the economic effectiveness of the companies economic hedges with respect to the risks that the hedges were intended by the company to address. Also, removing the shortcut and critical terms matching methods will increase the diversity in how hedged items and therefore hedge ineffectiveness are measured which will reduce comparability.

The most important concern that we have with this proposed statement is that companies will be forced by the distortions in this accounting standard to abandon prudent risk management strategies that we believe investors and other stakeholders would expect
them to implement (please see a recent article in the Financial Times that addresses the impact of commodity risks on corporate earnings: http://www.ft.com/cms/s/0/e197cf1c-6c81-11dd-96dc-0000779fd18c.html). We do not see how useful that is for the investor. In addition, the prohibitive and distorted accounting prescribed by the Exposure Draft puts U.S. companies at a competitive disadvantage with international companies from the perspective of risk management strategies available to international companies under IAS 39.

**Issue 4/Question 4a:** Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

We support the reduction in the threshold for hedge effectiveness in order to permit more hedge relationships to qualify for hedge accounting. We support the Board’s attempt to try to establish a model that accurately reflects hedge effectiveness to the extent that it exists. However, we think incorporating unhedged and unhedgeable risks goes too far beyond economic reality in an attempt to provide useful information. For those unhedged and unhedgeable risks, to the extent investors and equity analysts can clearly demonstrate why information about those risks are important to their investment decisions, then the FASB should require appropriate disclosures about those risks. We suspect that much of that information is already available or derivable from the current financial statements.

**Issue 4/Question 4b:** 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?

As discussed earlier, it is likely that most companies will not be able to qualify for hedge accounting under the Exposure Draft for hedges of fixed rate debt before or after the debt issuance date, especially given the comments of the two dissenting Board members in their “Alternative Views” outlined in paragraphs A52 – A 60 of the Exposure Draft. In addition, even hedges at the debt issuance date are also at risk of not qualifying as “reasonably effective” due to the requirements of paragraph 21(f) to consider all contractual cash flows when the designated hedged risk is benchmark interest rate risk. This is a flaw in our view from the drafting of the Statement 138 amendments by the FASB staff. It will become a significant GAAP difference should the Exposure Draft be passed.
Issue 4/Question 4c: 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 believe that U.S. “corporates” may stop hedging altogether or will reluctantly only hedge their debt upon issuance. We do not expect U.S. “corporates” to elect the fair value option because of the requirement to recognize unrealized gains and losses based on changes in their own credit spreads that would never be realized unless they were willing and able to repurchase their debt in the market.

They will be unable to modify their hedging strategy to incorporate other derivative instruments due to the reasons identified in the Alternative Views of the Exposure Draft - self dealing, etc. Quite simply, these derivatives do not and likely will not exist.

Issue 5/Question 5a: 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?

Absolutely. We believe that auditors will require every company to document and validate each quarter that “circumstances did not arise that would question whether a hedging relationship may no longer be reasonably effective.” We do not know how this could be done qualitatively especially if a company comprehensively complies with the new hedge documentation requirements of paragraph 10 of the Exposure Draft that requires identifying the sources of volatility associated with the hedged item or forecasted transaction. . .". The longer the list of sources of volatility, regardless of how insignificant or improbable of impacting the effectiveness of the hedge relationship, the more quantitative work and reassessments will be required of companies. We think even identifying one item in accordance with paragraph 10 will cause quantitative upfront and periodic assessments.

We believe the Exposure Draft will result in significant operational difficulties for U.S. companies. The FASB should have required only qualitative assessments of hedge effectiveness since the measurement of the hedged item is required to be done independently.

Issue 5/Question 5b: 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 do not believe that it would because we believe that the Exposure Draft will cause most if not all hedge relationships to be assessed quantitatively for the reasons stated earlier and for the same reasons we believe that companies will have to quantitatively reassess their hedges periodically. When you add in the requirement to consider
unhedged and unhedgeable risks, we believe that the Exposure Draft will lead to more hedges that would be disqualified due to the hedge accounting rules and not because of economic risk management considerations.

For example, for a "late hedge" of debt, one can easily envision the impact of credit on the change in fair value of the debt to cause it to change in the same direction as the change in fair value of the underlying interest rate swap that is never intended to hedge the issuer’s credit. In that case there would be zero offset and we believe that hedge accounting would no longer be permitted due to the impact of the unhedgeable risk on the hedge accounting.

**Issue 6/Question 6a: Do you agree with the Board’s decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective?**

Yes we do. However, we disagree with how the Board proposes to measure hedge effectiveness. We believe that companies should be able to hedge whatever risk that they deem appropriate to hedge and that the hedge accounting framework should be fluid enough to accommodate all types of hedges while at the same time properly accounting for and reporting economic hedge ineffectiveness based on the financial design and the intent of the hedge relationship. We believe that the hedge effectiveness measurement requirements of the Exposure Draft misrepresent the economic hedge effectiveness of many hedge relationships by creating "accounting ineffectiveness" and "accounting hedge concepts and relationships" that are disconnected from the economics. We believe that the Exposure Draft will increase the "accounting noise" in U.S. financial statements and may lead to certain hedge relationships not qualifying for hedge accounting or being deemed "ineffective" when they are highly effective from an economic, financial and cash flow perspective.

Based on our experiences, companies use derivatives for prudent, risk mitigating hedging strategies that are explicitly identified in a formal risk management policy that outlines counterparty, hedge ratio, tenor, and other limits imposed by senior management and the company’s board of directors.

When risk management activities are misrepresented in the financial statements, companies may alter or cease implementing those hedge strategies altogether. Doing so, however, negatively affects shareholder value when those unhedged risks result in realized losses or reduced operating margins.
Issue 6/Question 6b: 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?

Consistent with our comments above we would support not requiring reassessments of hedge effectiveness unless the FASB retained or expanded the shortcut and critical terms matching methods. In that case, we would support qualitative reassessments to assure that the critical terms still matched.

Financial Statement Presentation

Issue 7/Question 7: 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.

The disclosure requirements set forth in SFAS 161 provide sufficient information regarding the location of gains and losses recognized on derivatives and related hedged items in the financial statements, therefore, we do not believe that the issuance of further guidance regarding the presentation of gains and losses on derivative instruments is necessary.

Effective Date and Transition

Issue 8/Question 8: Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?

For the reasons stated above we do not support the issuance of the Exposure Draft because it would increase rather than decrease the complexity associated with the accounting for and reporting of hedging activities. Consistent with that, we believe that the proposed effective date would not provide nearly enough time for most companies to adopt the proposed Statement, especially given the long period that we expect the auditors and regulators will require to interpret many of the new provisions and then to broadly communicate those interpretations to U.S. companies. Eliminating the shortcut method, precluding benchmark interest rate hedging of forecasted debt, limiting benchmark interest rate hedging of recognized debt, and eliminating critical terms matching (including DIG Issue G20) will force U.S. companies to incur tremendous costs to understand, interpret, and implement those radical changes. Those costs will not be “one time” costs as asserted by the Board. The Exposure Draft will increase the cost base prospectively of companies to pay for the ongoing maintenance of the new systems and processes required, the people needed and the increased periodic hedge accounting requirements. The costs of the Exposure Draft will be far greater than that when one considers the hedging strategies that will be delayed, reduced, or eliminated altogether as U.S. companies deal with the proposed changes and await definitive interpretative
guidance from their consultants, auditors, and the regulators (including the FASB). Accordingly, implementation of the Exposure Draft will take a considerable amount of time and could take more time than was required when Statement 133 was originally issued due to the elimination of the shortcut and critical terms matching methods which will require considerably more systems requirements and human capital.

Most importantly, in light of the FASB’s recently renewed Memorandum of Understanding with the International Accounting Standards Board (IASB) to converge U.S. GAAP and IFRS, and the public support by certain U.S. organizations for a move toward a single set of global accounting standards in the near term, we question the merits of amending Statement 133 at this time, which would require U.S. companies to adopt new hedge accounting models twice in a relatively short time period.

Accordingly, we recommend that the Board halts this project in anticipation of the systematic adoption of IFRS in the U.S. The FASB should jointly develop a plan with the IASB to converge both IFRS and U.S. GAAP registrants to a global hedge accounting model at the same time.

**Issue 10/Question 10: 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 believe that the fair value option is relatively irrelevant for U.S. “corporate” companies for many of the same reasons that we disagree with many of the provisions of the Exposure Draft. Essentially, the fair value option would create distortions in a “corporate” company’s reported financial results and will increase the disconnect between the economic performance of its underlying business, risk management and financing strategies and therefore companies have not elected the fair value option to date.

**Benefit-Cost Considerations**

**Issue 11/Question 11: 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?**

The financial statements will not be more representative of the economics of the instruments designated as accounting hedges because bringing in unhedged and unhedgeable risks is not at all representative of the hedging instruments being used or the risk management activities of the enterprise. Evaluation of any strategy against metrics it is not intended or desired to achieve is an unreasonable basis to assess the performance, including the effectiveness of a hedge relationship. Further, we do not see how increasing “accounting volatility” would be useful to any user of a financial statement. Two companies that are exactly the same but experience different changes in the credit spreads on their debt will report different hedge effectiveness for their economic benchmark interest hedges and in fact one of those companies may not even qualify for
hedge accounting due to their credit spread volatility. If a company is hedging its interest rate risk why does the volatility of its own credit spread impact whether they will or will not qualify for hedge accounting? We do not see how that can improve comparability of risk management practices and is more representative of the relative economics of those companies hedging strategies.

As noted throughout this letter, the costs to implement at inception and ongoing will be tremendous as the Exposure Draft represents dramatic change in practice for U.S. companies. We disagree with the Board that the costs to implement will be “one time” costs as the Board asserts in paragraph A48. Regardless, the costs will be sizeable and incurred twice if U.S. companies have to transition again to an IFRS hedge accounting model. The following costs that the Board acknowledged in paragraphs A48 of the Exposure Draft include significant items, the costs of which should not be underestimated:

a. Costs to implement changes in systems and processes used to comply with the proposed hedge accounting guidance
b. Costs to initially develop methods to calculate overall changes in fair value of hedged items in fair value hedging relationships
c. Costs to initially develop methods for constructing the derivative that would exactly offset the hedged cash flows for use in measuring ineffectiveness in cash flow hedging relationships.

Other Comments

Paragraph 32 of the Exposure Draft

We understand that the Board intends to “grandfather” existing “late hedges” of an entity’s own debt from the “hedged risk designation” (paragraph 16), “measurement of hedged items” (paragraph 19), and “dedesignation at transition” (paragraph 32) requirements of the Exposure Draft. However, we do not believe that paragraph 32 is clear in that “late hedges” of an entity’s own debt as of the effective date of the final statement are also excluded or grandfathered from the “hedged risk (i.e., total risk) designation”, and “measurement requirements of the hedged item” for the remaining life of the hedge relationship. Some may read paragraph 32 to only give an exception to “late debt hedges” from the dedesignation requirement at transition as required by paragraph 32 and that it does not “grandfather” those hedge relationships from the requirements of paragraphs 16 and 19 of the Exposure Draft.
Proposed Changes to Paragraph 40 of Statement 133

The Board must clearly and comprehensively clarify their intentions and the basis for their conclusions for the proposed change to paragraph 40. There is considerable confusion regarding whether the amended text changes (or eliminates) current practice and or supersedes the functional currency concepts of Statement 52, which we would have thought would be outside the scope of this project.

→ What is a Late Hedge?

The term “late hedge” is a misnomer that we believe confuses people. What is a “late hedge” and why do you get different accounting for an otherwise equivalent hedge relationship? You are either hedged or you are not hedged. Additionally, why under DIG E23, can “late hedges” only occur for interest rate swaps hedging recognized fixed rate debt and it doesn’t afflict the exact reverse economic hedge, swapping floating rate debt to fixed? It is unclear why that the concept does not apply to any other hedge relationships (equity, FX, commodity, etc.) including fixed or floating rate foreign denominated debt that has been swapped into LIBOR in the issuer’s functional currency (also fair value hedges under Statement 133). The “late hedge” concept doesn’t even apply to other hedge relationships where only a component risk of the overall cash flows is being hedged (e.g. foreign currency risk). The basis for conclusions is noticeably sparse without any discussion on why this “late hedge” concept would only impact swaps hedging fixed rate debt and not other derivative instruments hedging other risks (FX, commodity, equity) including other types of debt hedges where discounts and premiums also exist.

All else being equal, why is a hedge any more or less effective based on the timing of execution? This is a very hard, if not impossible, concept to explain to non-accountants and accountants that do not support the “late hedge” principle. Once the swap is executed its fair value will be driven by all changes in the designated hedged benchmark rate from that point forward. Therefore, the hedge doesn’t perform any differently and the designated hedged risk doesn’t change, so what changes?

It might be easier to explain our concerns if we express the concept as we understand it for another type of risk – equity, foreign currency, commodity, etc. For example, if a company bought ABC stock 2 years ago, and given the current market turmoil it decided that it wanted to hedge its exposure to prospective changes in the price of ABC stock, if it executes an equity forward to sell the ABC stock than it is hedged for all prospective changes in the equity price just as effectively as if it hedged that ABC stock the instant that it was bought. The accounting assessment and measurement results under Statement 133 are exactly the same regardless of when the equity risk or any other risk is hedged. Why does DIG E23 propose different accounting based on time of execution for only one specific hedge strategy and not for any other strategy?

We believe that the answer to all of those questions above is that Statement 133’s paragraph 21(f) conflicts with the economic design and principle of benchmark interest rate hedging relationships by requiring that a hedge that is intended economically and designated accordingly to only hedge (or “unlock”) a component of the total debt instrument’s cash flows must be analyzed based on the total instrument’s cash flows. That requirement directly conflicts with the objective of the hedge – to unlock only a
portion of the debt’s overall cash flows. The remaining fixed cash flows remain unaffected and accordingly should not be analyzed as part of the assessment or measurement of the hedge relationships effectiveness. Evaluating the hedge relationship for something it is never intended or capable of achieving is like comparing an apple to an orange. An interest rate swap is not designed to offset changes in cash flows that comprise treasury risk, swap spread risk, credit spread and changes thereof prior to the inception of the hedging relationship.

It follows logically that only a component of the hedged debt instrument’s cash flows must be analyzed to ensure the analysis is consistent with the economic function of the hedge. Under IAS 39, the same exact hedge does not perform any differently at issuance or thereafter because IAS 39 correctly allows the hedge to be assessed consistent with the intended purpose and actual economic reality of the hedge - to hedge (“unlock”) changes in fair value of the benchmark interest rate component cash flows of the hedged item.

The objective of the hedge is not to hedge changes in the fair value of the overall hedged item due to only changes in a single underlying as one might infer based on the guidance added to paragraph 21(f) in Statement 138. Hopefully our illustration below clarifies economically how benchmark interest rate hedges work and enables people to become more comfortable with the shortcut method. Further, we hope that despite the name shortcut, it becomes clear that the hedging relationships are being accounted for and reported properly under the shortcut method of hedge accounting.

To explain this further, we believe it is helpful to review how benchmark interest rate hedges work economically and how companies that use that hedge strategy are thinking about the overall hedge relationship.
Cash Flow Hedge

NOTE: The effect of the swap is to "lock in" or fix only the benchmark component cash flows of the bank loan. The benchmark LIBOR rate in this case is a 3 month floating rate. All other cash flows remain unaffected/unhedged and are not considered when evaluating the effectiveness of the swap to fix only the LIBOR benchmark component cash flows of the loan. The FAS 133 long haul method assessment and measurement rules are consistent with the true economics of this component cash flow hedging relationship.

Fair Value Hedge

NOTE: The effect of the swap is to "unlock" or float only the current at-market benchmark component cash flows of the issued debt. The fixed cash flows on the debt over and above the at-market benchmark LIBOR swap rate (the hedged item) are unhedged or unaffected by the swap and therefore should not be evaluated in determining the effectiveness of the swap to float only a portion of the debt's fixed cash flows. By extension, since those cash flows are unaffected by the hedge, it follows that the accounting for the unhedged cash flows should also remain unchanged (debt accounting). The net effect of the hedge is completely accounted for by the shortcut method as asserted by the three dissenting Board members. The unhedged cash flows that remain fixed continue to accrue as before as interest expense. Any discount or premium also continues to be amortized as required. The only potential source of mark-to-market ineffectiveness comes from changes in the current market 3m LIBOR rate in between the 3m LIBOR reset dates on the floating leg of the interest rate swap.
We strongly believe that the above illustration is what was always intended in principle by Statement 133 when the Board decided to permit benchmark interest rate hedges and directed the staff to draft paragraphs 68-70 and 114-115 in the original version. Statement 133 was not originally issued with the conflicting guidance in paragraph 21(f). It was actually added by the FASB staff during the amendment of Statement 133 by Statement 138 two years after the issuance of Statement 133 (and also there was some natural turnover of some of the FASB staff that worked on drafting Statement 133). We believe that the staff that drafted Statement 138 had a different understanding or interpretation of paragraphs 20, 21(a), 21(f), 68-70, 114 and 115 when adding "clarifying" language to paragraph 21(f) in Statement 138. Paragraphs 68(dd) and 540 (Benchmark interest rate) were also added at that time (please see our recommendations for corrections to those paragraphs as well within our letter).

Accordingly, given that two years had passed since Statement 133 was originally issued and with a different staff member or two or more added to the project team working on Statement 138, it is understandable how conflicts within Statement 133 arose as a result of the various amendments (it was also amended by Statement 149) like the one between (1) paragraph 21(f) and (2) paragraphs 68, 69, 70, 114, 115 and various related implementation guidance (which specifically permit debt hedges that meet the criteria of paragraph 68 to be accounted for consistent with the economic illustration above regardless of hedge timing). Additionally, the word "recognized" was inserted into paragraph 68 by Statement 138, and that insertion, without clarifying that hedging swaps entered into on the pricing date of the debt though before the settlement date of the debt does not preclude application of paragraph 68, is the reason E23 is clarifying the trade date versus settlement date issue.

Though we support clarifying existing guidance accordingly, those errors, excluding the text added to paragraph 21(f), that occurred in the drafting of Statement 138 were generally corrected in practice to date. Again, the reason that the conflicting guidance that was added in paragraph 21(f) went relatively unnoticed until recently is because

---

2 Paragraph 69 was inserted to address the common practice of companies and their bank counterparties grossing up both legs of the interest rate swap by the same spread so that the fixed coupon on the swap aesthetically matches the contractual coupon of the hedged debt. That practice is done regardless of whether the swap is executed at the issue date or thereafter. For example, if a company issued 5-year debt at 7% fixed (e.g., 200 basis points above the then current at-market benchmark LIBOR swap rate of 5%), and swapped it immediately into 3m LIBOR, the interest rate swap trade confirmation would have the company paying 3m LIBOR + 200 basis points and receiving 7% fixed. Accordingly, the effective swap rate is actually 5% and not the 7% coupon on the hedged debt. The economic effect of the swap is to unlock only the benchmark LIBOR swap rate component (i.e., 5% at current market) of the total debt coupon (i.e., 7%) to successfully effect a net economic interest expense profile of 3m LIBOR + 2% (i.e., 200 bps). The difference between the at-market swap rate (i.e., 5%) and the debt coupon (i.e., 7%) represents the unhedged portion or component of the debt and accordingly remains unchanged by the swap.
paragraph 68, 114 and 115 and related guidance prevented people from having to apply the requirements of paragraph 21(f) until recently.

Other reasons that we believe that paragraph 21(f) conflicts with benchmark interest rate risk hedging economics and principles include:

- It is inconsistent with how interest rate swaps are designed to function economically as illustrated above.
- It is inconsistent with the accounting prescribed in paragraph 68 - that is paragraph 68 (shortcut method) is effectively applying a long haul method using an approach that is consistent with the illustration above. That is, the same result can be achieved with the shortcut method under a long haul method that models the hedged cash flows as the component benchmark LIBOR cash flows of the debt instrument which would match the fixed rate on the hedging interest rate swap. The only difference is that the shortcut method allows you to ignore the short term mark to market noise of the floating LIBOR leg of the swap between the LIBOR reset dates.
- The errors in paragraphs 68(dd) and 540 (Benchmark interest rate) also indicate that the benchmark component hedge concept may not have been fully considered during the drafting of Statement 138.
- It is consistent with the fact that at market swaps to fixed or swaps to floating achieve the intended result equally as well – i.e., to change the cash flow profile of only the current LIBOR benchmark component cash flows of the hedged item
- The above illustration is how IAS 39 evaluates those hedge relationships.
- The principles of IAS 39 are almost word for word the same as Statement 133’s principles.
- It is inconsistent with how cash flow benchmark interest rate hedges are required to be assessed based only on the component floating cash flows that are fixed by the swap.
- The process described in paragraph 21(f) for benchmark interest rate hedges would be applicable to hedges of the overall fair value of the total cash flows of the hedged item that would be appropriately hedged with a total return swap and not an interest rate swap.
- Practitioners, auditors and users are uncertain how to apply Statement 133’s long haul approach in accordance with paragraph 21(f) for fixed rate debt hedges (there is no such confusion under IAS 39).
- There is no single approach to applying Statement 133’s long haul approach in accordance with paragraph 21(f) for fixed rate debt hedges (not the case under paragraph 68 or IAS 39).
- It would constitute another significant GAAP difference with IFRS – that is the hedged item would be defined differently for fair value benchmark interest rate hedges under the two frameworks.
- The resulting income statement under 21(f) is misleading and incorrect in that it does not reflect the actual cash flows of the hedged relationship.
• The reason everyone has difficulty applying 21(f) in practice is that it does not faithfully represent the economics of a benchmark interest rate fair value hedging relationship (please see the June 2006 ISDA presentation).

• Modifying paragraph 21(f) as suggested herein will also eliminate another GAAP difference with IFRS for partial term hedges of fixed rate debt. Statement 133 in principle explicitly permits partial term fair value hedges of debt, though no one has ever been able apply the requirements of paragraph 21(f) to that hedge and meet the highly effective requirement. However, IAS 39 recognizes that a swap that unlocks certain fixed cash flows of a longer term fixed rate instrument is highly effective at achieving that objective and accordingly easily qualifies for hedge accounting.

Based on the above, if the Board ultimately decides to curtail or eliminate the use of the shortcut method, Statement 133 should be amended to converge to the economically correct assessment and measurement principles of IAS 39 thereby eliminating the existing GAAP difference for those hedge relationships including partial term hedges of fixed rate debt. In fact, by amending the shortcut method in a way that forces more companies to apply the Statement 133 long haul method, the Board is actually moving from one unconverged state to an even further unconverged state as the IFRS GAAP difference is significantly greater for the long haul method as compared to the shortcut method for fair value debt hedges under Statement 133. It is also relevant to note that because the long haul method is actually not a prescribed single approach, the GAAP difference will actually differ for each company depending on how they interpreted and applied Statement 133’s long haul method (reducing comparability of financial statements).

→ What are Some of the Consequences of the Inconsistency Contained in Paragraph 21(f)?

The inconsistency of the paragraph 21(f) assessment and measurement approach with the economics of an interest rate swap is the reason the long haul method increases complexity and therefore accounting/restatement risk and at the same time will reduce comparability of financial statements even among issuers who hedge the same remaining tenor of debt on the same day. Companies will each report different results in their income statement under the paragraph 21(f) long haul approach due to the various ways each company considers whether and how to account for each of the below items:

• Whether the debt is newly issued or not,
• Differences in credit,
• If hedging existing debt then how much has the benchmark interest rate changed from issue date to the hedge date,
• Whether they include or exclude accrued interest,
• Whether they include or exclude the effects of the passage of time,
• What discount rates are used,
• What amortization method is used to amortize basis adjustments of the debt as a result of hedge accounting
• How they will account for the initial difference between the beginning “FAS 133 carrying amount” and the actual balance sheet carrying amount of the debt at the inception of the hedge,
• What part of the forward curve are they going to evaluate for period over period changes.

How a company addresses those various decision points will result in each company having a bespoke long haul method approach due to the numerous different combinations that are possible given the number of decisions and the ability in most cases to choose between two or more alternative approaches. That assumes that each company implements the similar approach in the same manner and using the same data. The lack of detailed implementation guidance allows for the various long haul method permutations that are occurring in practice.

Because of the current requirements of paragraph 21(f), very few, if any, “late hedge” long haul hedge relationships would consistently pass under the dollar offset approach. Accordingly, every company that we are aware of that is doing a fully comprehensive quantitative long haul approach in accordance with paragraph 21(f) is using regression to assess hedge effectiveness. If the questions above on long haul and the questions below on regression are not addressed concurrent with the issuance of E23, we believe that we could see more restatements occurring because of differing interpretations or re-interpretations of those issues:

• What constitutes a valid regression?
• What R² is required?
• What beta is required?
• Do I look at the t-test or the F-test, or both?
• How many data points are necessary? Daily, weekly, monthly?
• What period of time must the historical data be derived from?
• Do I regress price levels or changes in price?
• What confidence interval do I use?
• Who is Durbin-Watson and what does he think of my regression?

Hopefully, as a result of the comment letter process, the Board firmly understands how complexity, accounting/restatement risk and implementation issues will be significantly increased and that diversity in practice is assured should the “late hedge” provisions of proposed E23 be codified.

→ What is so Ineffective About an Interest Rate Swap?

We believe it was understood and acknowledged over ten years ago that hedges of recognized debt were one of, if not, the most vanilla and straightforward hedge strategies commonly executed by companies globally. We understood that it had been agreed that those hedge relationships were so clearly quantitatively and qualitatively
highly effective, if not perfectly (in some cases), that not much work was necessary to demonstrate or measure ineffectiveness. Yet now, one of the effects of E23 is to propose an accounting framework for these clearly vanilla hedge relationships that would cause the debt hedge with a vanilla interest rate swap to be accounted for as one of the most ineffective hedges (from a dollar offset perspective) of any other type of hedge strategy that qualifies in principle under Statement 133 except for certain proxy risk hedges. How is this possible? Again, none of this is an issue under IAS 39 which has many hedge accounting principles including the fair value hedge principle that are almost word for word in line with Statement 133 (see underlined areas below for comparison).

**IAS 39 Excerpts:**

*Designation of Financial Items as Hedged Items*

81 If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument). [Emphasis added]

86 Hedging relationships are of three types:

(a) *fair value hedge*: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.

(b) *cash flow hedge*: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.

(c) *hedge of a net investment in a foreign operation* as defined in IAS 21. [Emphasis added]

**FAS 133 Excerpts**

*Fair Value Hedges*

**General**

20. An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof ("hedged item") that is attributable to a particular risk. Designated hedging instruments and hedged items qualify for fair value hedge accounting if all of the following criteria and those in paragraph 21 are met: [Emphasis added]

*The Hedged Item*
21. An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following criteria are met:

f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is

(1) the risk of changes in the overall fair value of the entire hedged item,

(2) the risk of changes in its fair value attributable to changes in the designated benchmark interest rate (referred to as interest rate risk), [Emphasis added]

(3) the risk of changes in its fair value attributable to changes in the related foreign currency exchange rates (referred to as foreign exchange risk) (refer to paragraphs 37, 37A, and 38), or

(4) the risk of changes in its fair value attributable to both changes in the obligor’s creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge (referred to as credit risk).

The only material difference between the Statement 133 literature and the IAS 39 literature with respect to fair value hedges of recognized debt is the conflicted text added by Statement 138 a subparagraph to paragraph 21(f) of Statement 133 that is underlined below:

Paragraph 21(f) Excerpts
If the risk designated as being hedged is not the risk in paragraph 21(f)(1) above, two or more of the other risks (interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62, the use of different benchmark interest rates for similar hedges should be rare and must be justified. In calculating the change in the hedged item’s fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item’s contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.* An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity’s exposure to changes in the overall fair value of that “prepayment” option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an
embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of interest rate risk.

* The first sentence of paragraph 21(a) that specifically permits the hedged item to be identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment is not affected by the provisions in this subparagraph.

For the reasons outlined above, we recommend that paragraph 21(f) be amended in the following manner to eliminate conflicts within Statement 133 that would resolve numerous implementation issues and also eliminate a significant GAAP difference with IAS 39:

21. An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following criteria are met:

f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is

(2) if the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as the benchmark interest rate component of the total interest rate exposure of a hedged financial instrument), the risk of changes in its fair value attributable to changes in the designated benchmark interest rate (referred to as interest rate risk);

If the risk designated as being hedged is not the risk in paragraph 21(f)(1) above, two or more of the other risks (interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62, the use of different benchmark interest rates for similar hedges should be rare and must be justified. In calculating the change in the hedged item’s fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on only all of the benchmark interest rate component of one or more of the contractual cash flows of the entire hedged item. Excluding some of the hedged item’s contractual cash flows (for example, the portion of the interest coupon in excess of the
benchmark interest rate) from the calculation is consistent with the designated hedge risk as permitted by paragraphs 21(a) and 21(f)(2) and is also consistent with the economic design and intention of hedging relationship not permitted.

An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity’s exposure to changes in the overall fair value of that “prepayment” option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of interest rate risk.

*The first sentence of paragraph 21(a) that specifically permits the hedged item to be identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment is not affected by the provisions in this subparagraph.

We would also recommend amending paragraph 20 in the following manner to alleviate any possible confusion:

20. An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof, such as one or more selected contractual cash flows or portions of them or a percentage of the fair value, ("hedged item") that is attributable to a particular risk. Designated hedging instruments and hedged items qualify for fair value hedge accounting if all of the following criteria and those in paragraph 21 are met: