

ISDA

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April 3, 2000

Mr. Timothy Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856

Re: File Reference No. 207-A

Dear Mr. Lucas:

The International Swaps and Derivatives Association (ISDA) would like to take this opportunity to express its views on the Financial Accounting Standards Board's (FASB) Proposed Statement of Financial Accounting Standards, *Accounting for Certain Derivative Instruments and Certain Hedging Activities – an amendment of FASB Statement No. 133* (the "Exposure Draft").

ISDA is the global financial trade association representing leading participants in the privately negotiated derivatives industry. ISDA's 460 members include commercial, merchant and investment banks, corporations, government entities, and other institutions engaged in the swaps and derivatives business as dealers, end users, or service providers. A list of ISDA's members is included.

General Comment

ISDA supports the changes the Board has proposed in its Exposure Draft to amend Statement No. 133. Many of the changes proposed were suggested in ISDA's comment letter dated January 11, 2000, prior to the Board's reconsideration of these issues. Our comments on the provisions of the Exposure Draft are noted below as well as concluding comments on the accounting for net purchased option premiums and the grandfathering of intra- and intercompany interest rate hedging derivatives.

Hedging the Risk Free Rate

We support the changes proposed to allow companies to hedge the "benchmark" interest rate rather than just

limiting interest rate hedges to the “risk-free rate.” This change will be helpful in the hedging of interest rate risk on new issuances by allowing designation of the underlying benchmark interest rate. However, we also believe that the restriction on AAA entities from designating the LIBOR swap rate as the hedged rate unfairly penalizes high grade companies. Even AAA companies often have a credit spread above LIBOR, and we do not see any reason why having an all-in rate above LIBOR should make hedge accounting more appropriate than a sub-LIBOR rate. We would propose allowing AAA companies to designate the LIBOR swap rate as a hedge of the LIBOR swap component of their borrowing rate. We do not believe that this would distort results and is consistent with allowing the short-cut method for swaps on debt regardless of the credit rating of the hedging entity. This comment on the AAA rate is equally applicable to investments and loans held.

With respect to the examples illustrating this issue, we have the following comments:

Example 1: We do not believe that using treasury futures is the common means for corporations to hedge their exposure on future debt issuances. Most use OTC treasury locks to lock in the forward treasury rates consistent with the expected maturity of their bond issuances. While using a hedge that considers the duration is important, when using treasury futures against longer duration bonds, we believe that using the appropriate OTC treasury lock would eliminate the need to hedge in this manner and the gain or loss on the derivative would offset the change in present value of the cash flows of the future debt cost if the credit spread component of the coupon is ignored (as it seems to be in the revised example). The result would be that the hedger could assume there would be zero ineffectiveness if it selected a treasury lock on the appropriate forward treasury rate (similar to the result in Example 2). We believe it is important for the FASB staff to include an example showing this result because 1) treasury locks are the most common form of future debt issuance hedging and 2) it would make clear that there are circumstances where an assumption of zero ineffectiveness is appropriate for a hedge of the treasury component. Leaving Example 1 as the only indication of how these provisions work for hedging the risk-free benchmark rate fosters the misconception that a ratio/duration hedge would always be required even if treasury futures are not used as the hedging instrument.

With respect to Example 2, we support the answer given. This is what we expected based on the language in the Exposure Draft.

The comments above are based on our best understanding of how the examples work given the limited information provided. We would recommend that for all examples, adding specific detail on how the change in value of the hedged item was calculated would be very helpful. Also, adding journal entries would make the examples more useful to financial statement preparers and users. Once this information is included, we reserve the right to have additional comments. We agree with the Board’s decision on March 29 that the examples are important and that they should be included in the Staff Implementations Guidance so they can be properly vetted through the DIG process.

Providing Hedge Accounting for Foreign Currency Assets and Liabilities

The changes to Statement No. 133 that will permit hedge accounting for foreign currency debt instruments, both issued and held, result in a major improvement in the standard. Hedge accounting is needed to better match the results of hedging these instruments back to a company’s functional currency.

While the accounting for a cash flow hedge acknowledges that there may be no hedge ineffectiveness if the foreign currency side of a cross currency interest rate swap is perfectly matched against the issued debt, the accounting afforded fair value hedges should similarly produce a zero hedge ineffectiveness result if the cash flows from the foreign currency debt are perfectly matched by the cross currency interest rate swap. The same criteria that apply in paragraph 68 of Statement 133 should also apply in this situation. If the criteria are all

met for a fair value hedge of foreign currency debt swapped back to the functional currency of the issuer, then an assumption of zero ineffectiveness should apply and the change in fair value of the swap should be deemed to be the change in fair value of the debt instrument, eliminating potential ineffectiveness from differences in bond vs. swap spreads.

Extending the Exception for Normal Purchases and Sales

We strongly support the extension of the exception for normal purchases and sales to contracts that have explicit or implicit net settlement features if physical delivery is probable. This will eliminate a significant reporting burden for many commercial and industrial companies and avoid difficult issues on what constitutes “a market mechanism” for many contracts that are in substance merely purchase orders. We understand the decision to exclude futures contracts from qualifying for this exception and, therefore, support the Staff’s Implementation Guidance G2 on “All in One” hedges.

Central Treasury Netting

Many companies use central treasury functions to manage the enterprise's net interest and/or foreign currency risk across subsidiaries. We support the Board’s decision to permit netting for foreign currency intercompany contracts for cash flow hedges of anticipated transactions. However, we were extremely disappointed that a broader application of this netting procedure to apply to hedges of interest rate risk and other foreign currency transactions (such as fair value hedges) was not permitted.

Issues Rejected by the Board for Amendment

In its reconsideration, the Board decided not to change the accounting for net purchased option premiums nor provide relief to financial institutions with respect to intra- and intercompany interest rate contracts that were executed between the loan and funding books and the trading book. We request that the Board reconsider its decisions in these areas for the reasons discussed below. Addressing these two issues would go far in addressing the remaining significant concerns with Statement No. 133.

1) Hedging Using Purchased Options

As we noted in our January 11, 2000 letter, one of the most negative results of the requirements of Statement 133 is that net purchased option hedges produce the most volatile earnings results when the changes in the time value component must be treated as ineffectiveness from period to period. Many of our members who develop option hedging strategies for their clients have seen a significant drop in interest in using purchased options as part of prudent risk management programs due to the expected volatility, even though their clients have real economic risks which these instruments could mitigate while retaining upside potential. We were very disappointed that the Board appeared to give this issue a superficial reconsideration given the severity of the risk management dislocation created by this accounting.

Further, we believe that, within the context of Statement 133, some accommodation can be made to adjust the treatment of static option hedges. We previously suggested that purchased options should be carried on the balance sheet at fair value (to meet the Board’s requirement that the fair value of derivatives be readily apparent in the financial statements), but that changes in premium “time” value be recorded in other comprehensive income (OCI) each period. The original premium amount would be amortized to earnings on a straight-line basis as the cost of the hedge, adjusting OCI. While we would not have required a positive intent to hold options accounted for in this manner to maturity to achieve this accounting, we would support this concept, as articulated in Statement No. 115 and already being used for held to maturity debt securities, if it would enable companies that elect to designate the option as held to maturity to display the changes in option premiums on both fair value and cash flow hedges in OCI and not record them in current earnings. We

do not believe that implementing a held to maturity approach would be a significant burden to derivative end users and the result would fall within the spirit of Statement No 133's cornerstones. At maturity of these held-to-maturity options, all ineffectiveness, that is, the option premium, would have been taken to earnings and since the options would be held to maturity, there would be no opportunity for triggering unrealized gains or losses in earnings due to non-recognition of changes in the time and volatility value of net purchased option hedges. Where a derivative user does not elect to designate its intent to hold an option to maturity, the current accounting in Statement No. 133 would apply.

We believe this offers a reasonable position that will reduce the accounting disincentive to use options and allow companies to focus on the economic benefits of using purchased options to hedge. It is also a simple approach to describe and implement that would not delay the passage of an amendment of Statement 133.

2) Grandfathering Intra- and Intercompany Interest Rate Derivatives

Many members of ISDA are facing a significant reporting burden and costly exercise to try to match up pre-1999 intra- and intercompany contracts executed for the loan and funding books with third party contracts in the trading account. Some of these contracts are long term in nature and, thus, in many cases would require the financial institution to execute new contracts with similar terms in order to achieve hedge accounting under Statement No. 133. (Please note that a recent DIG issue would preclude the use of the short-cut method if a new contract was entered into since that swap would almost always have fair value at inception if it matched an old exposure.). Having to match up old contracts in this manner will be a costly exercise and add more credit risk to the market as financial institutions have to execute contracts with outside dealers in order to establish a one-to-one relationship between internal and external contracts. By not permitting the "unhedged" exposure to be part of the trading account balance that is marked to market through earnings, the FASB is mandating a noneconomic exercise that imposes increased credit risk and process burden.

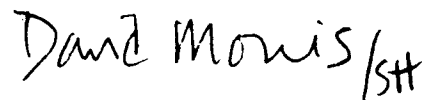
We urge the Board to reconsider its decision on this matter. Financial institutions have already adopted the one-to-one approach in Statement No. 133 for contracts entered into after January 1, 1999. Relief in this matter would enable financial institutions to focus on the rest of the requirements of Statement No. 133, which has the greatest and most varied impact on financial institutions.

Again, we appreciate the opportunity to comment on the Exposure Draft and support the FASB's efforts in this regard. Representatives of ISDA are available to discuss our comments with you should you so desire.

Very truly yours,



Richard Grove
Executive Director and CEO



David Morris
Co-Chairman
Accounting Committee