

# ISDA

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March 2, 2007

Mr. Larry Smith  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**Re: File Reference No. 1510-100, Proposed Statement of Financial Accounting Standards,  
*Disclosures about Derivative Instruments and Hedging Activities***

Dear Mr. Smith:

The International Swaps and Derivatives Association (“ISDA”) is pleased to provide the following comments with respect to the Financial Accounting Standards Board’s (the “FASB”) proposed Statement of Financial Accounting Standards, *Disclosures about Derivative Instruments and Hedging Activities* (the “Exposure Draft”). ISDA members represent leading participants in the privately negotiated derivatives industry and include most of the world’s major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.

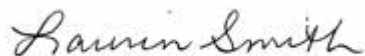
In summary, ISDA does not support the Exposure Draft as currently proposed. While we are supportive of meeting users’ desires for additional transparency about how and why an entity uses derivative instruments and the impact of derivatives on an entity’s financial statements, the level of disaggregation required by the Exposure Draft is not needed to meet the stated transparency objective. We believe that the proposed requirements, and the basis for conclusions, reflect an unresolved conflict between a desire to require more risk disclosures and the knowledge that such disclosures are not meaningful under the current scope of the project. ISDA strongly believes that risk information should be communicated through risk metrics (such as VAR, Stress, BPVs, etc.) on portfolios as a whole, and not through accounting information, such as notional amounts, and disaggregation of realized versus unrealized gains perceived to be still at risk. Accordingly, we believe that the requirements of the

Exposure Draft should be reevaluated in light of its stated objective, with particular focus on whether the disclosures are meaningful or provide utility for an entity with more than a handful of derivatives. Further, we believe that any perceived need for additional risk disclosures for public companies should be addressed through an amendment to Regulation S-K Item 305 Quantitative and Qualitative Disclosures about Market Risk, and not in a limited scope disclosure project whose outcome is reflected in the footnotes to the financial statements.

ISDA also does not support the Exposure Draft's narrow scope, which focuses only on derivative instruments, and the creation of another unique framework of disclosures specific to certain instruments. The provisions of the Exposure Draft would require disclosures that would be incremental to disclosures about financial instruments and their fair values that are required under other GAAP, such as SFAS 107, SFAS 157 and SFAS 159. We believe that creating another set of unique disclosures for financial instruments whose attributes, cash flows, and fair values are disclosed elsewhere in the footnotes will result in a level of disaggregation that will impair, rather than improve, the overall usefulness and relevance of the information presented in financial statements. Additionally, we believe that the Exposure Draft will significantly increase the volume of information disclosed in the financial statements for large users and dealers of derivatives, such as many of our organization's members, and may contribute an additional eight to twelve pages to financial reports during the initial year of adoption and twenty to thirty pages during subsequent years in which comparative information is presented. Accordingly, we recommend that the FASB incorporate the objectives and scope of this project into its broader Conceptual Framework project regarding Presentation and Disclosure for the purposes of harmonizing the population of disclosures regarding fair value.

Should the FASB decide to issue disclosure guidance with respect to derivative instruments and hedging activities as proposed, we ask that it consider our recommendations to the Exposure Draft enumerated in the paragraphs that follow. Primary among those recommendations is to convene a public roundtable consisting of a broad, representative group of preparers and users to assist in the determination of meaningful and cost-effective disclosures for entities with significant derivatives activity. We hope you find ISDA's comments 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,



Laurin Smith  
*J.P. Morgan Chase & Co.*  
Chair, North America Accounting Policy Committee  
*International Swaps and Derivatives Association*  
212.648.0909

**Paragraph 1 – Objective**

The Exposure Draft lists the following objectives for issuing guidance with respect to the disclosure of derivative instruments and hedging activities.

- How and why an entity uses derivative instruments;
- How derivative instruments and related hedged items are accounted for under Statement 133; and,
- How derivative instruments affect an entity’s financial position, results of operations, and cash flows.

It is our understanding, based on the above stated objectives, that the Exposure Draft seeks to improve the transparency of derivative instruments and related hedged items designated in qualifying hedging relationships under Statement 133 in financial reporting. We believe that the stated objectives of the Exposure Draft do not, however, reconcile to the Board’s Basis for Conclusions and certain of the information required to be disclosed. Our view is based on the following observations.

While a number of the Board’s statements in the Basis for Conclusions (including those noted in paragraphs B19, B21, B22, and B30) indicate that the objective of the Exposure Draft is to provide improved transparency of an entity’s use of derivative instruments, many of the Board’s conclusions focus on a fourth objective— disclosures of derivative and enterprise risks. For example, paragraph B29 concludes that, “Presenting notional amounts and fair value amounts on a gross basis would better indicate the potential future effect that changes in the underlying would have on the value of the derivative, given the current environment for the underlying.” Additionally, paragraph B31 states that, “One of the main criticisms of the current disclosure requirements in Statement 133 is that they provide little information about the effect that derivatives have on the risk profile of the reporting entity.” These remarks are in conflict with the Board’s rejection in paragraph B13 of the risk disclosure objective.

We believe that many of the Exposure Draft’s required disclosures attempt to both increase transparency in financial reporting (the Board’s stated objective) and improve disclosure of risk management through the use of derivatives (the Board’s rejected objective). Our view is based on the following examples of risk-focused disclosure requirements, which the Exposure Draft’s Basis for Conclusions indicate are intended to provide information about risk management (as noted above).

- Notional amounts of derivatives (paragraph 44C(a)).
- Estimated magnitude that leverage factors have on a derivative’s notional amount and underlying risk (paragraph 44C(e)).
- Maximum amount of loss due to credit risk that an entity would incur if parties to the derivative completely fail to perform (paragraph 44E(a)).

We also believe that the level of disaggregation required for the tabular disclosures is reflective of the implied risk disclosure objective and not transparency, as the impact and financial statement location of derivative information would be more clearly understood in a more

summarized fashion. Based upon our review of the Exposure Draft and discussion with the FASB Staff, we understand that there could be up to seven tables. The example table in the Exposure Draft requires one full page to explain only a handful of derivatives. We question whether the eight to twelve pages (and approximately twenty to thirty pages in years after initial adoption) of additional footnote disclosure likely needed for a derivatives dealer to meet the proposed requirements would meet the objective of increasing transparency or whether the sheer volume and disaggregated nature of the disclosures would impair transparency.

Based on discussions with equity analysts at ISDA member firms, we are aware of divergent views regarding the derivative information that would meet user needs, and of concerns regarding whether the disclosures proposed would be useful to users who follow large financial institutions. We therefore request that the FASB consider whether its objectives in issuing the Exposure Draft have been met, taking into consideration the costs and benefits of the information required to be disclosed by preparers and that it align the requirements and the Basis for Conclusions with those objectives. In doing so we recommend that the FASB convene a public roundtable consisting of a representative preparer and user group from whom it can elicit feedback on what information regarding derivatives should be disclosed, especially with respect to entities with significant derivatives activity. If the objectives resulting from this roundtable are to improve the disclosure of an entity's risk management practices, then we recommend that this matter be addressed, for public companies, by the SEC in Regulation S-K Item 305 Quantitative and Qualitative Disclosures about Market Risk. We firmly believe that risk-related disclosures should be made using risk metrics, and not accounting information.

### **Paragraph 2 – Scope**

If, the objective of the Exposure Draft is intended to encompass enterprise risk-related information, then we do not believe that the scope is sufficiently comprehensive, and further do not believe that this represents a project that should be undertaken by the FASB for public companies, but rather the SEC.

With respect to transparency alone, we also disagree with a limited scope project for derivatives disclosures, given that its provisions will require disclosures incremental to those already required under GAAP (for example, SFAS 107, SFAS 157 and SFAS 159) regarding financial instruments and their fair values. We believe that creating another set of unique disclosures for a select group of financial instruments whose attributes, cash flows, and fair values are disclosed elsewhere in the footnotes does not improve the overall usefulness and relevance of the information presented in financial statements.

We recommend that the FASB incorporate the objectives and scope of this project into its broader Conceptual Framework project regarding Presentation and Disclosure. However, if FASB's objective is solely transparency and it decides to issue limited guidance regarding the disclosure of derivative instruments and hedging activities, as proposed under the Exposure Draft, then we ask the FASB to consider our views expressed in the comments that follow.

**Level of Aggregation**

Paragraph 44C of the Exposure Draft requires separation by primary underlying risk, accounting designation and purpose (i.e., financial statement line item or forecasted hedge item) of all of the following information;

- The absolute value of notional amounts related to derivative instruments that are reported in the statement of financial position that are held at the end of the reporting period;
- Location and fair value amounts of derivative instruments that are reported in the statement of financial position;
- The location and amount of gains and losses reported in the statement of financial performance (or when applicable, the statement of financial position) on derivative instruments and related hedged items held at the end of the reporting period; and,
- The location and amount of gains and losses reported in the statement of financial performance (or when applicable, the statement of financial position) on derivative instruments that existed during the reporting period but are no longer held at the end of the reporting period or are no longer in a designated hedging relationship at the end of the reporting period.

*Primary Underlying Risk*

As previously noted, we understand that an entity may need to develop and present up to seven tables representing each risk or risk combination being hedged, including the separate presentation of derivatives containing multiple underlying risks.

Though we do not object to increased transparency of derivatives in financial reporting, we believe that disclosing derivatives with multiple risks separately adds complexity and cost to tracking and accumulating information without a corresponding benefit to users of financial statements. For example, we note that almost all derivatives technically incorporate interest rate risk and thus could be considered to have multiple underlying risks requiring separate presentation. We believe that disclosure of the primary risk should be sufficient. We further believe that decreasing the number of tables and length of the overall disclosures would aid clarity and comprehension of the overall derivative activity. Accordingly, we recommend that the FASB allow entities to elect to disclose the information required under paragraph 44C only by the primary underlying risks, as defined in Statement 133, without separate tables for multiple risks.

*Quantitative Disclosures*

While we find the example interest rate underlying disclosure table to be helpful in understanding the proposed requirements in paragraphs 44 and 45, we recommend that the table be amended to reflect the minimum requirements only. Reliance on the table may lead preparers

and their auditors to misunderstand the disclosure requirements expressed in the body of the standard. For example, although shown in the table, we do not believe that segregation of gains and losses and notional amounts by whether the derivative is in an asset or liability position is required by the proposed paragraph 44C. (Further, we do not believe such disclosure should be required, for the reasons stated in paragraph C99 of Statement 157's Basis for Conclusions).

As another example, we do not believe that current period ineffectiveness (the amount of gains/losses recognized in income on the derivative) in a cash flow hedge is a minimum requirement for the tabular disclosure. We do not believe disclosure of this information is useful on the level at which it must be disaggregated within the table and believe that the benefits of providing this information to financial statement users outweigh the costs of tracking and accumulating it. We also note that this information is not given the same prominence in the table for fair value hedges. We recommend that the FASB remove the ineffectiveness disclosure from the table.

### **Paragraph 44C – Balance Sheet and Income Statement Disclosures for Derivatives**

#### *Notional Amounts*

The Exposure Draft requires disclosure of the absolute value of notional amounts related to derivative instruments that are reported in the statement of financial position for every interim and annual reporting period for which a statement of financial position is presented. This disclosure requirement applies to derivatives that are in designated and qualifying hedging relationships as well as to undesignated derivative instruments.

The Exposure Draft's Basis for Conclusions indicates that requiring disclosure of derivative notional amounts would provide insight into the overall volume of derivative use and the magnitude of risks being managed. However, due to the limited scope of the project which does not include disclosure of net enterprise risks using meaningful risk-based metrics, we do not believe the disclosure is useful. In fact, we believe that disclosure of notional information may be misleading to users. For example, assume an entity uses a hedging strategy designated under Statement 133 that employs the use of a series of 12 one-month forwards, each having a notional amount of \$1.0 million, to hedge an entity's exposure to \$1.0 million of benchmark interest rate risk that resets each month over a period of 12 months ("Strategy 1"). In contrast, assume that entity also has another hedging strategy whereby it uses a single \$1.0 million notional interest rate swap with monthly resets to hedge benchmark interest rate risk over the same 12 month period ("Strategy 2"). Strategy 1 and Strategy 2 are identical in terms of the risks they are intended to hedge. As currently drafted, the provisions of the Exposure Draft would require the entity to disclose \$12.0 million notional of interest rate risk for derivatives designated under Strategy 1, while the entity would disclose \$1.0 million notional of interest rate risk for Strategy 2. Many such examples exist in which notionals create unreliable perceptions of risk. We therefore believe the requirement to disclose the notional amount of derivative instruments is not useful, but misleading for both derivatives designated and not designated in qualifying Statement 133 hedge relationships. We anticipate that significant additional qualitative disclosures would be necessary in order to address user confusion which is foreseeable as a result of the proposed

disclosures. Such qualifying remarks would likely indicate that notional amounts are not a measure of risk, but are used simply as a reference to calculate payments.

We recommend that the FASB eliminate the requirement to disclose notional amounts for all derivatives. If however, the FASB determines that such information is necessary for qualifying Statement 133 hedge relationships, we recommend that the FASB eliminate the need to disclose the notional amounts of derivatives and allow entities to instead disclose the effective notional/face amounts of the hedged items for the reasons illustrated immediately above. As it pertains to derivatives not designated in qualifying hedges, we believe that notional amounts can only be intended to provide information about risk being managed by an entity, and accordingly, we believe that such disclosures are properly addressed in Regulation S-K Item 305 Quantitative and Qualitative Disclosures about Market Risk for public companies.

### *Leverage*

The Exposure Draft requires disclosure of the estimated magnitude of leverage on derivative notional amounts and underlying risk. This disclosure requirement applies to derivatives that are in designated and qualifying hedging relationships as well as to undesignated derivative instruments.

We believe that the disclosure of the magnitude of leverage on derivative notional amounts for derivative instruments designated in qualifying hedging relationships may be misleading to users of financial statements since it could imply that there are exposures within derivatives that are not incorporated into, or offset by, the hedged item. However, given the stringent effectiveness criteria that must be met in order for hedging relationships to qualify for hedge accounting pursuant to Statement 133, a corresponding amount of exposure would invariably need to exist within the hedge item. As such, we recommend that the FASB remove the requirement in the Exposure Draft to disclose the effect of leverage on derivative instruments designated in qualifying hedging relationships pursuant to Statement 133.

For derivatives not designated in qualifying hedge accounting relationships under Statement 133, we also do not believe the disclosure is meaningful. As leverage describes notional amounts and since we believe that misperceptions arise from notional disclosure, we also recommend elimination of the leverage requirement. Leverage is embedded in the valuation of the derivative but not tracked as a separate attribute for any risk management purpose. For large derivative dealers, the impact of leverage is likely to be quite small in relation to the population of hundreds of thousands of derivative positions, and very costly to find, track and disclose. In addition, we are unclear how to define leverage, or how to report it numerically in relation to the breadth of a dealer portfolio.

### *Gains and Losses*

Paragraph 44C(d) of the Exposure Draft requires disclosure of the amount of gains and losses on derivative instruments that are held at the end of the period separate from derivatives that existed during the period but that are no longer held at the end of the reporting period.

We fail to understand why separate presentation of gains and losses held at the end of the period versus those no longer held is meaningful. These disclosures appear to be intended to allow users to highlight which revenue is unrealized, and therefore subject to reversal due to market risks. However, we do not believe such distinction between realized and unrealized gains and losses are relevant in a fair value measurement attribute. We also note that hedge accounting relationships are required to meet very stringent offset criteria, both in the current period, and in expectations for future periods, so any reversals of prior period gains on a derivative should be highly offset by corresponding changes in the hedged item's fair value or cash flows. Accordingly, we believe the disclosures should reflect, and not attempt to negate, the fair value measurement attribute for the instrument, and believe that the quality of derivative earnings is sufficiently addressed in Statement 157's disclosures.

If the purpose of the disclosure is to provide additional transparency to the cash flow statement, we strongly believe that such an objective can be met with more clarity and less cost in the aggregate. We therefore recommend that the FASB delete this requirement from the final Statement.

### **Disclosure Requirements – Frequency**

The Exposure Draft requires all of its proposed disclosures to be made both in interim and annual periods when statements of financial position and financial performance, respectively, are presented. We believe that entities for which derivatives are significant to their business and/or significantly affect their financial statements would voluntarily make the proposed disclosures in both their interim and annual financial reports. However, entities whose use of derivatives is not significant but nonetheless is an aspect of managing their exposures may find a quarterly frequency to be onerous. Accordingly, we strongly encourage the FASB provide an election for entities for which derivatives are not significant to their business and whose derivative activities have not significantly changed from the previous annual period to disclose the information required under the Exposure Draft on a quarterly basis.

### **Effective Date**

The Exposure Draft would be effective for interim and annual reporting periods ending after December 15, 2007. We note that the Exposure Draft would require disclosure of information pertaining to the current year that is not being tracked and accumulated by entities, not withstanding the fact that a final standard is not expected to be issued until sometime during the second quarter, thus requiring entities to implement its provisions in a very short period of time. For that reason alone, we believe that the proposed effective date will result in significant implementation issues among preparers and is likely to make timely compliance with most of the Exposure Draft's provisions impossible.

As previously noted in the preamble of this letter, we also believe that the Exposure Draft will significantly increase the volume of information disclosed in the financial statements for large users and dealers of derivatives. Compliance with the Exposure Draft's provisions will therefore require significant time and effort as well as systems enhancements. We do not believe that its proposed effective date permits entities sufficient time for transition and implementation of its

disclosure requirements, even if the transition provisions were changed to be fully prospective. As such, we strongly urge the FASB to delay the effective date until fiscal years ending after November 15, 2008. This recommended effective date would also improve comparability in financial reporting between entities that have fiscal years ending in November, as is typical in the broker-dealer industry, and those that have calendar year-ends.

#### **Paragraph 44D – Disclosure of Contingent Features**

The Exposure Draft requires disclosure of the following, for every interim and annual period for which a statement of financial position is presented:

- Existence and nature of contingent features and circumstance in which such features could be triggered in derivative instruments held at the end of the reporting period;
- Aggregate fair value amounts of derivative instruments that contain contingent features; and,
- Aggregate fair value of assets that would be required to be posed as collateral or transferred in accordance with the provisions related to the triggering of contingent features.

The Exposure Draft does not specify what constitutes a “contingent feature” within a derivative instrument that would require disclosure of the above noted information. The Basis for Conclusions provides several examples of contingent features within derivative instruments that would require disclosure of the information prescribed by paragraph 44D. Although these examples appear to be focused on credit-related events, a principal governing which contingencies within derivative instruments must be disclosed is not clearly communicated in the body of the standard. Given the pervasive existence of contingent features in derivative contracts, including those pertaining to non-credit specific events (e.g., price triggers within option contracts, early termination events, contingent dividend pass through provisions, etc.), we recommend that the FASB revise paragraph 44D of the Exposure Draft to incorporate the following modification.

An entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42) shall disclose for every annual and interim reporting period for which a statement of financial position is presented:

- a. The existence and nature of contingent features specifically related to an entity’s requirement to post additional collateral as a result of a reduction to its credit worthiness, such as a one-notch downgrade by one of the major rating agencies, and the circumstances in which the features could be triggered in derivative instruments (and nonderivative instruments) that are held at the end of the reporting period.
- b. The aggregate fair value amounts of derivative instruments (and nonderivative instruments) that contain those features.

c. The aggregate fair value of assets that would be required to be posted as collateral or transferred in accordance with the provisions related to the triggering of the contingent features.