



July 28, 2006

Mr. David R. Bean
Director – Research and Technical Activities
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Project No. 26-4P, Preliminary Views on Major Issues Related to Accounting and Financial Reporting for Derivatives

Dear Mr. Bean:

The Bond Market Association (“TBMA”)¹ and the International Swaps and Derivatives Association (“ISDA”)² are pleased to offer the following comments in response to the Governmental Accounting Standards Board’s (“GASB” or “Board”) Preliminary Views document on major issues related to *Accounting and Financial Reporting for Derivatives* (the “Preliminary Views document”).

The comments that follow were developed and are being presented jointly by a working group (the “Joint Industry Working Group” or “JIWG”) composed of representatives of the Municipal Financial Products Committee³ of TBMA and the accounting policy committee of ISDA. Collectively, the membership of these committees has substantial

¹ The Bond Market Association (“the Association”) represents securities firms and banks that underwrite, distribute and trade debt securities domestically and internationally. The Association’s member firms account for in excess of 95 percent of all primary issuance and secondary market trading activity in the U.S. debt capital markets, including the issuance, underwriting and trading of securitized instruments. More information about the Association and its members and activities may be found at its internet website, located at www.bondmarkets.com.

² ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 725 member institutions from 50 countries on six continents. These members include most of the world’s major institutions that deal in privately negotiated derivatives, 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. Information about ISDA and its activities is available on the Association’s web site: www.isda.org.

³ The Bond Market Association’s Municipal Financial Products Committee consists principally of dealers in the market for derivatives in which the end-user is a borrower of the proceeds or an issuer of tax-exempt debt (e.g., U.S. governments and non-profits).

professional expertise and practical experience addressing the accounting policy issues and questions raised by this proposal with respect to financial instruments.

The JIW G comm ends the G A S B 's efforts to im prove the accounting for and disclosure of derivatives and hedging activities by governmental entities. As previously communicated, TBMA continues to believe that a disclosure model is a more appropriate model than a recognition model given the unique aspects of governmental entities, including the fact that such entities do not report earnings. This view is further supported by input provided to TBMA and the GASB from financial statement users and the capital markets community. Thus, TBMA believes that Technical Bulletin 2003-1 already provides a meaningful basis for disclosures regarding derivatives and hedging. Notw ithstanding T B M A 's view that a disclosure m odel is preferable in governm ental accounting, the JIW G recognizes G A S B 's view that the best m easurem ent attribute for the reporting of derivatives is fair value and thus has set forth below specific comments and suggestions on the Preliminary Views document. We hope you find the comments informative and beneficial.

Requirement of Hedge Accounting

We recognize that the GASB believes that given the long-term nature and intent to hedge, the gain/(loss) on the derivative relates to future transactions, and, accordingly, the deferral provisions of this document are conceptually superior to marking derivatives to market with changes in the change statements. Given that view, it seems illogical to require significant effort by preparers to achieve the outcome that the GASB prefers. The path to the G A S B 's preferred outcom e should be easier. By requiring hedge accounting rather than providing an election, the proposal may create illogical incentives, such as providing perceived benefits to structuring a hedge that would fail hedge accounting, improperly designating a derivative, or incorrectly applying hedge accounting. The efforts to meet the requirements of hedge accounting are significant. Our experience with corporations, who generally have more staffing and financial resources, is that many have elected to live with the income statement volatility of mark-to-market accounting in order to forgo the cost to meet hedge accounting requirements.

We also believe the Board should consider the costs relative to the benefits of requiring users to perform effectiveness assessments for essentially all derivatives. Due to regulatory requirements, most, if not all derivatives are entered into for non-speculative purposes and therefore this requirement to apply hedge accounting would be applicable for virtually every derivative. The proposed GASB methodology may lead preparers to seek information that is often not readily available and/or is impractical for most entities to obtain. For example, complex debt and swap models with access to historic yield curves and interest rate volatilities (for callables) are needed to analyze past changes in fair values. Given the costs and complexities of applying hedge accounting there is concern that the assessment requirements may cause users to not enter into derivatives

and not hedge real economic risk. Therefore, we recommend that if the GASB's preferred model is the deferral method, that such method be required for all hedges without the burden of meeting the hedge accounting requirements, but that entities may elect to record changes to the change statement. This approach would simplify the process for users and achieve what the GASB considers the most appropriate accounting.

Alternatively, the GASB could reconsider the requirement to apply hedge accounting to all derivatives and allow entities that believe the costs (resources and operations) are excessive to elect to mark derivatives to fair value with changes in the change statements rather than to elect hedge accounting with the associated requirements. Gains/(losses) in the change statements would be clearly identifiable in the disclosures. The requirements and rigor to assess effectiveness should also be simplified so that implementation of the deferral method, if elected, is not excessively burdensome to entities.

Termination and Change of Intent

Chapter 3, paragraph 4 states that "management may not change its objective or intent for a derivative with respect to a specific hedgeable item once it has been declared." Additionally paragraph 27 notes that "the Board proposes that hedge accounting normally cease to be applied when a termination event occurs and the deferral should not be reported in future periods."

From these paragraphs, it is clear that the GASB will not allow an entity to terminate a hedging relationship between a derivative and a hedged item voluntarily, but only upon specific termination events. We understand that this is related to the rationale that the GASB believes deferral accounting is preferable. However, since an entity's risk profile or risk management objective could change, we also believe an entity should be able to dedesignate a hedge and cease to apply hedge accounting.

In addition, derivatives are used to hedge debt that will be rolled over. It is not uncommon for the terms of the new debt to be different than the terms of the original debt. However, under certain conditions, Statement 133 permits these future interest payments to be hedged with the initial derivative without terminating hedge accounting. We recommend that the GASB clarify that (a) evaluation of hedge effectiveness is not required when terms change on floating rate debt being hedged as long as the index is the same and (b) the change in terms does not represent a termination event and result in the recognition of the deferred amount in the change statements.

Consistent Critical Terms Method

If the GASB does not eliminate the inconsistency of requiring hedge effectiveness testing in order to apply its preferable accounting, then the JIWG is supportive of the consistent critical terms method as it will be less burdensome than other methods to evaluate

effectiveness. However, we believe the scope of the consistent critical terms method should be expanded. Chapter 3, paragraph 13(a) of the Preliminary Views document requires that the hedging derivative be a swap, but we believe it should be applicable to other derivatives that have terms that match those of the hedged item, such as forward contracts. If the terms of a forward and a hedged item match then the hedge will be perfectly effective.

Paragraph 13(e) requires the index on which the variable leg of the swap is based be the same as the benchmark rate that is being hedged in the hedging relationship. This requirement does not provide clarity as to whether the consistent critical terms method can be used for hedged items that are not indexed, such as auction rate securities. We believe that if an entity is hedging a highly rated, tax-exempt floating rate security, including an auction rate security, it should be able to use the consistent critical terms method when using a derivative with an index of BMA.

We would also ask the GASB to consider whether the hedged risk could be a percentage of LIBOR when hedging a tax-exempt instrument. The use of percentage of LIBOR swaps is greater than that of BMA swaps given that LIBOR indexed swaps are often more cost effective hedges. In paragraph 16 of SFAS 138's Basis for Conclusions, the FASB considered factors supporting the use of a second benchmark interest rate (LIBOR in addition to US Treasury), and concluded that the prevalence of the use of LIBOR swaps as a hedging instrument, technical factors, and the inability of common hedging relationships to qualify for hedge accounting were persuasive arguments for allowing a second benchmark interest rate to be designated. In the government market, similar considerations support the designation of both BMA and LIBOR (or a percentage of LIBOR) as benchmark interest rates and therefore the application of consistent critical terms for commonly used hedges. We recommend that the GASB acknowledge that percentage of LIBOR swaps are an industry practice and an effective hedge, and therefore, allow the use of the consistent critical terms method for swaps indexed to a percentage of LIBOR.

We believe that the consistent critical terms method as written would apply to forecasted transactions. However, we are unclear as to what would be required if the terms of the forecasted transaction change and accordingly, the hedge would no longer be perfectly effective. We recommend that the GASB clarify that a hedge of an expected transaction would qualify for the consistent critical terms method and that upon an event that causes the critical terms to no longer be consistent, effectiveness would need to be evaluated using one of the other methods. Additionally, the Board should clarify that another method may be used to evaluate effectiveness since paragraph 11 states "the same method of evaluation used to assess effectiveness at inception should be used to evaluate effectiveness over the life of the hedge."

It is common for entities to hedge new debt issuances with forward starting swaps. If the consistent critical terms method cannot be used for these hedges they may need to be evaluated using quantitative techniques as it is currently unclear how to apply the synthetic instrument method to forward starting hedges. This would add significant complexity and burdens to frequently encountered transactions. Accordingly, we recommend that GASB clarify that forward starting swaps may qualify for consistent critical terms and also that, if upon issuance of the forecasted transaction, the forward starting swap transaction no longer qualifies for consistent critical terms, the entity is permitted to then apply either the synthetic instrument method or quantitative techniques.

One of the requirements to use the consistent critical terms method is that the fair value of the swap be zero at inception of the hedging relationship. There are challenges in meeting this requirement. We recommend that the GASB clarify that bid-ask prices should not cause one to determine that the fair value of a swap is not zero.

Hybrid Instruments

The Preliminary Views document requires that when there is an upfront payment for a derivative an entity must identify it and account for the debt/financing component separately. Therefore, the GASB proposal would require an option premium to be separated into intrinsic value and time value with the intrinsic value recorded as a financing. The most effective hedge, and one commonly used to hedge debt that has an in-the-money call, is a swaption with intrinsic value. The Preliminary Views document would require the intrinsic value in the swaption to be recorded as debt; however, the asset it was hedging is not recorded. We question whether this asymmetrical result is appropriate.

Breaking out intrinsic value and time value requires a potentially complex series of calculations and creates an artificial instrument, the "time value" component (which is not equivalent to an at-the-money option⁴). The Preliminary Views document describes the time value as simply the difference between the total option value and the intrinsic value. This is a simplistic analysis, because time value is not a standalone attribute, but relates to the existing intrinsic value of the option. Moreover, we foresee significant complexity in marking-to-market this artificial component over time since it is an artificial, not freely tradable instrument and pricing assumptions will vary, potentially dramatically. In addition, the classification of components of a derivative as debt will have implications to meeting debt covenants which also need to be better understood. Even without a requirement to separately record debt for hybrid instruments, a derivative liability would be reflected in the balance sheet reflecting the inherent obligation.

⁴ A true at-the-money option premium value is not equal to the difference between 1) an in-the-money option premium, less 2) the intrinsic value of the option. Pricing assumptions (volatility) for at-the-money options differ from those of in-the-money options. Generally, an at-the-money option will use a higher volatility assumption than an in-the-money option.

Accordingly there would be no off-balance sheet obligations. We recommend that the GASB reconsider its definition of embedded financing and the requirement to bifurcate a derivative and separately record debt.

Additionally, the bifurcation guidance in the Preliminary Views document is insufficient for practical application. The guidance in Chapter 2, paragraph 12 notes that for an instrument to be a hybrid “the economic characteristics and risks of the derivative are not closely related to the economic characteristics and risks of the companion instrument.” However, there is no guidance to determine whether the economic characteristics are closely related to the companion instrument or examples illustrating the application of the guidance given. Additionally, there is little guidance on the subsequent accounting for the proposed components to be bifurcated, such as whether a bifurcated derivative could be used as a hedge. Further, for practical application, we believe a materiality threshold should be established for the bifurcation criteria.

Quantitative Techniques to Evaluate Effectiveness

While we agree that regression is an appropriate method to evaluate effectiveness, we believe there are other statistical methods that could be used to evaluate effectiveness (e.g. value-at-risk, volatility reduction method). We recommend that the GASB not proscribe regression and dollar offset as the only methods to evaluate effectiveness if an entity cannot use either the consistent critical terms method or the synthetic instruments method. Additionally, when using regression to evaluate hedge effectiveness there are various appropriate methods (e.g. regressing rates) in addition to regressing the fair values, as required in the Preliminary Views document. We recommend that the GASB not specify a method for performing a regression.

Paragraph 18 notes that for the dollar-offset method the evaluation of effectiveness may be made on a current period or a life-to-date basis. This suggests that the entity must select a method upfront and continue with that method throughout the life of the hedge. However, for the synthetic instruments approach, paragraph 15(g)(4)(i) allows an entity that has first evaluated the payments made in the current period to determine if they are in the acceptable range for effectiveness, and if they are not, to then evaluate the hedge on a life-to-date basis. This approach could also apply to the dollar-offset method so if the current period failed to show high effectiveness due to the law of small numbers, an entity should be able to perform the evaluation on a life-to-date basis. We recommend that if a hedge is believed to have failed effectiveness due to the law of small numbers the Board allow constituents to use an alternative method, such as a stress test of the interest rates, or a life-to-date dollar offset evaluation to determine whether that hedge is still highly effective. We further comment that it would be preferable that the different effectiveness methods have similar application.

When using the dollar offset method over the life of the hedge we believe that to evaluate effectiveness at hedge inception the entity should be able to choose an observation period that is reasonable, especially for long-dated trades. Consider a hedge of the interest payments on a 30-year debt instrument. Trying to obtain the past 30-years of data to perform a retrospective test for a 30-year instrument is extremely difficult. Data is not easily obtainable; for example, Bloomberg only has the necessary data for the period beginning in 2001 to the present. Paragraph 15(g)(3) requires that for the synthetic instruments method a retrospective evaluation use data “for a representative period of time.” We suggest that as long as the data set is statistically valid and representationally faithful it be allowed for all methods of evaluating effectiveness.

Synthetic Instruments as a Method to Evaluate Hedge Effectiveness

The JIWG is supportive of the synthetic instruments method to evaluate hedge effectiveness and believes it represents a simplification of evaluating effectiveness. However, the JIWG questions why the actual synthetic rate is required to be within a range of 90% to 111% of the fixed rate of the hedging derivative when a range of 80% to 125% is allowed for the dollar-offset method. If hedge accounting with deferrals of gains/(losses) is the GASB’s preference, then we recommend not having a requirement to perform ongoing assessments of effectiveness after the inception of the hedging relationship. However, if the GASB firmly believes that assessments should be performed subsequent to the initial assessment, then the JIWG recommends that a range of 80% to 125% be used for determining effectiveness when using the synthetic instruments method to be consistent with the dollar-offset method and historic views on what constitutes a highly effective hedge in the non-governmental market.

Additionally, the Board specifically acknowledges in paragraph 18 that the dollar-offset method “can produce problematic results when there are small fair value or cash flow changes compared to the value of the hedged item and hedging derivative.” The law of small numbers issue will arise whenever a ratio is used for evaluating effectiveness. Therefore, the synthetic instrument method is also susceptible to this issue. It is not clear from the Preliminary Views document whether the Board believes that if a hedge fails effectiveness testing solely due to the law of small numbers it would be deemed an ineffective hedge. We believe that hedges that fail effectiveness testing solely due to the law of small numbers should not be disqualified from hedge accounting. As previously discussed, we recommend that if a hedge is believed to have failed effectiveness due to the law of small numbers that the Board allows constituents to use an alternative method, such as a stress test of the interest rates or a life-to-date dollar offset evaluation, to determine whether the hedge is still highly effective.

Paragraphs 15(c) and 16(c) require that “the variable rate is based on the same index” for the derivative and the hedged item. However, paragraphs 15(g)(1) and 16(g)(1) only require that payments made on the hedged item “are based, in whole or in part, on one variable interest rate, and payments received on the hedging derivative are based, in

whole or in part, on a second variable interest rate that is substantially the same as the first interest rate.” These provisions seem to contradict one another and recommend that the Board clarify paragraphs 15(c) and 16(c). It is not clear if the intent is that the hedging instrument and hedged item have the same exact index or substantially the same. It is also unclear if the derivative must have the same index throughout its life. It is not uncommon for governmental entities to use a swap with two indices and we recommend that in those situations the synthetic instruments method be applicable.

Paragraphs 15(g)(3) and 16(g)(3) require an entity to establish, at inception of a hedge being evaluated using the synthetic instruments method, the expectation that the aggregate payments are fixed on a retrospective basis. To establish this requirement on a retrospective basis the entity must use the term of the hedge as a basis for how much market data must be used. However, if an entity uses quantitative techniques instead of the Synthetic Instruments method paragraph 20 requires it to establish effectiveness on relevant historical data that considers the period of time that the swap will be effective. Paragraph 20 states that “a government that plans to enter into a four-year swap to hedge cash flows would determine the fair value of a similarly termed four-year swap and the fair values of a four-year hypothetical derivative for enough previous periods to yield statistically valid results that the hedge is expected to be either effective or not effective.” We believe that the method to establish effectiveness at inception of a hedge for the quantitative methods reduces the administrative and operational burden of obtaining historic data but does not diminish the validity of the results by inclusion of the phrase “enough previous periods to yield statistically valid results”. As previously discussed, we recommend that as long as the data set is statistically valid and representationally faithful it be allowed for all methods of evaluating effectiveness.

Written options in a synthetic refunding

The Preliminary Views document requires that if a written option for a synthetic refunding expires worthless, the associated liability from the hybrid (the intrinsic value) be reclassified as a valuation account attributable to the existing debt similar to an unamortized bond premium in proprietary funds and government-wide financial statements. This account is then required to be amortized as an adjustment to interest expense over the remaining life of the outstanding bonds that were not refunded. However, in the government market, we believe that the written option is used as a fair value hedge of the option embedded in the debt and therefore, if not exercised, the intrinsic value should be reclassified to earnings when the written option expires.

Transition

Chapter 5, paragraph 1 specifies that “accounting changes adopted to conform to the provisions of an eventual standard for derivatives would be applied retroactively by restating financial statements, if practical for all prior periods presented.” We do not

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believe that retroactive application by restating financial statements for prior periods presented is the appropriate transition method as it may have unintended consequences. By requiring retroactive application, certain debt covenants that were met in previous years may no longer be met by restating those prior periods. Therefore we recommend that the provisions of a final standard be applied by adjusting the beginning balance of net assets.

Disclosures

We believe the disclosure requirements under Technical Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets* ("TB 2003-1"), provide users with important information for derivatives that are not recognized and measured at fair value by states and local governments. However, once derivatives are recognized and measured at fair value in financial reports we question the need to expand upon all of the disclosure requirements of TB 2003-1, rather than evaluate which disclosures are necessary to complement the proposed recognition model. Requiring entities to recognize and measure derivatives and evaluate effectiveness will require significant resources. While increased disclosure is always preferable if cost or the ability to discern key risks amid volumes of information is not at issue, we believe that a balance between quantity versus transparency and cost is required. Therefore we recommend streamlining the disclosure requirements to focus on the items most important to users.

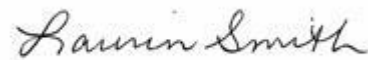
Conclusion

The JIWG appreciates the opportunity to provide the foregoing comments and reiterates its general support for the PV giving note to the comments above. Should you have any questions or desire any clarification concerning the matters addressed in this letter, we would be pleased to meet with you to discuss these matters.

Sincerely,



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The Bond Market Association

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Municipal Policy Committee

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