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Mr. Russell Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference Number 1810-100, Proposed Accounting Standards Update: *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

Dear Mr. Golden:

The International Swaps and Derivatives Association's (ISDA) Accounting Policy Committee¹ appreciates the opportunity to provide comments and observations on the Financial Accounting Standards Board's ("FASB") Exposure Draft of Proposed Accounting Standards Update: *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the "Exposure Draft").

ISDA is supportive of the FASB's efforts to simplify the accounting for financial instruments and derivatives and hedging activities in a comprehensive fashion. ISDA particularly welcomes the proposed relaxation of the criteria applicable to when an economic hedge can qualify for hedge accounting. While ISDA broadly welcomes many of the changes to the accounting for derivatives and hedging, we have identified areas for which further clarification and enhancement is warranted.

The Exposure Draft is proposing major changes to the recognition and measurement criteria for a considerable number of financial instruments and, as a result, will have wide implications for most reporting entities. ISDA will continue to support fair value as the most relevant measurement attribute for derivatives and for financial instruments in the trading book. However, in other cases, the use of fair

¹ ISDA's Accounting Policy Committee 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.

value may not always achieve two of the principles which underscore financial reporting: faithful representation and usefulness. The majority of our members are of the view that the amortized cost measurement attribute provides the most decision-useful information for debt instruments which have relatively basic cash flow characteristics and which are held for the purpose of collecting (or paying) the instruments' contractual cash flows (versus the realization of gains or losses through sales or settlements). Therefore, ISDA is of the view that the classification and measurement model within IFRS 9, *Financial Instruments*, and the IASB Exposure Draft, *Fair Value Option for Financial Liabilities*, represent a more decision-useful approach to the reporting of financial instruments than the model proposed in the Exposure Draft. ISDA is also concerned with the FASB's decision to diverge from the IASB's 'Classification and Measurement' model within IFRS 9 and the implications that it may have for the convergence to a single, high quality accounting model, following the recommendations given by the SEC, the G20 and other multilateral institutions after the 2007/8 economic crisis.

Within the remainder of this letter we have summarized our key messages in response to the FASB's Exposure Draft and in the Appendix attached we have provided more detailed observations and responses to the questions included in the Exposure Draft.

Key Messages:*Classification and Measurement*

- The majority of our members are of the view that the amortized cost measurement attribute provides the most decision-useful information for debt instruments which have relatively basic cash flow characteristics and which are held for the purpose of collecting (or paying) the instruments' contractual cash flows (versus the realization of gains or losses through sales or settlements). The requirement to measure instruments with the aforesaid cash flow characteristics at fair value on a recurring basis will reduce the reliability of amounts reported in the financial statements, reduce comparability in financial reporting among similar entities, especially for loans and finance receivables, and introduce significant operational complexity that carries a cost which has not been adequately justified. We also question how measuring debt instruments with simple cash flow terms that are held in a traditional banking book or issued for long-term funding purposes provides decision-useful information to financial statement users. Therefore, ISDA would support a model that permits loans, finance receivables, and issued debt to be measured at amortized cost if an entity has a business strategy of collecting or paying the contractual cash flows associated with these instruments.
- ISDA members do not support a recognition model which generally requires an entity's own issued debt (for example, plain vanilla short-term and long-term debt) to be measured at fair value and believe that the proposed criteria for measuring such liabilities at amortized cost are lacking a principle that is in line with the economic objectives of how these instruments are managed. The requirement to measure an entity's own debt at fair value (either through other comprehensive income or net income) exacerbates the counterintuitive results arising from including changes in an entity's own credit risk (including the general price of credit) in the fair value of a liability that were observed during the recent credit crisis for entities which elected to carry their own debt at fair value under the fair value option. We question how the reporting of counterintuitive results for a significantly larger population of financial instruments improves the usefulness of an entity's statements of financial position and operations. We therefore recommend the final standard permit broader application of the amortized cost measurement approach for an entity's own issued debt that has relatively plain vanilla terms.

- The proposed requirement to measure all financial assets and liabilities at fair value through net income if they contain one or more embedded derivatives requiring bifurcation under Topic 815 may produce unintended consequences especially when the embedded derivative contributes to a small portion of the financial instrument's overall fair value. As such, the proposed classification and measurement model should be modified to provide preparers an option either to bifurcate embedded derivatives from hybrid financial instruments or carry such hybrid instruments in their entirety at fair value with changes in net income. The election to bifurcate would allow companies to account for the terms of a hybrid financial instrument that do not represent a derivative (i.e., the debt host contract and any clearly and closely related features that qualify as non-bifurcable derivatives) based on management's business strategy for these instruments.
- Related to our comment immediately above, ISDA strongly recommends requiring the portion of the changes in fair value of a hybrid financial liability measured at fair value with changes in net income related to changes in the entity's own credit risk (based on the methodology prescribed in ASC Topic 820) to be recognized in other comprehensive income. As changes in own credit risk associated with hybrid financial liabilities issued for longer term funding purposes are generally not realizable (i.e., if the entity repays the contractual amount, the cumulative effect over the life of the instrument of any changes in the liability's credit risk will net to zero because its fair value will equal the contractual amount), presentation of changes in an entity's own credit risk in other comprehensive income more faithfully represents the income statement impact underlying these liabilities. Moreover, as an entity is often unable to hedge changes in its own credit risk (due to reputational risks or legal issues), the requirement to recognize these changes in net income will invariably result in significant earnings volatility that will never be realized if the liability is repaid under its contractual terms. Presentation of changes in an entity's own credit risk in other comprehensive income for hybrid financial liabilities is also consistent with the IASB's proposed classification and measurement guidance included in the *Fair Value Option for Financial Liabilities* Exposure Draft.
- ISDA disagrees with the proposed accounting model required for equity-method investments and private equity investments. We have three principal concerns. First, the proposed conditions for applying the equity-method of accounting erode the usefulness and reliability of the investor's financial statements since most investments which provide for significant influence are made for strategic purposes; they are not made to benefit from short-term changes in fair value. In many cases there are significant barriers to entry for certain markets to which an investor would like to gain access and an investment which provides significant influence may be the most efficient way to gain access. Therefore, the investee's operations may not always be related to the investor's consolidated operations when the investment is initially made. Second, similar to investments which provide for significant influence, investments in private companies which do not provide for significant influence are also commonly made for strategic or long-term investment purposes and in many cases are made to gain access to new technologies or create new business relationships. Third, the proposed changes to the accounting for equity investments would unnecessarily complicate the accounting for all investments in private companies that do not qualify for the equity method because the information needed to reliably estimate fair value each reporting period is often not available on a timely basis. Thus, ISDA believes the cost method of accounting is most appropriate for private equity investments held under certain business models.

Hedge Accounting

- ISDA is supportive of the FASB's efforts to simplify the accounting for hedging activities, relax the qualifying criteria for applying hedge accounting, and resolve certain practice issues that have arisen under Statement 133 and notes that several of the Exposure Draft's proposed changes will

lead to significant improvements in the current hedge accounting model. However, there are several significant practice issues that were not addressed in the Exposure Draft including the following.

- Elimination of the shortcut method: While the elimination of the shortcut method and the critical terms matching criteria will eliminate preparer concerns regarding the consequences of unintentionally misapplying the two aforementioned methodologies (e.g., with corresponding or attendant risk of restating financial statements), new concerns and practice issues will arise, such as the ability for companies to comply (operationally) with the “long haul” calculations prescribed in Topic 815. Moreover, the elimination of the shortcut method without a practical replacement does not achieve the Board’s goal of simplification, as the existing “long haul” calculations required for fair value hedges are complex and generally require sophisticated risk management systems and infrastructure to carry out. This is a widespread and pervasive issue of particular concern to issuers of fixed rate debt (especially issuers of high yield debt or callable debt) that wish to swap their debt to a floating rate in a fair value hedge.

In addition, companies that swap fixed-rate debt with the sole objective of changing the interest coupon characteristics from a fixed-rate to a floating rate will be required to record ineffectiveness under the long-haul calculations which is not economic and will reverse itself by the maturity of the hedging instrument and hedge relationship. We believe that the FASB’s focus on “rooting” out any ineffectiveness which it seems to think exists by prescribing how the change in a hedged item’s fair value attributable to changes in the designated benchmark interest rate should be determined (see paragraph 24 of Statement 138) is causing unnecessary complexity in the current fair value hedge accounting model. In the interests of simplicity both in applying the hedge accounting rules and for the benefit of financial statement users who currently find the more simplified approach readily understandable, we strongly urge the FASB to provide a more simplified approach in the final Financial Instruments Accounting Standards Update. ISDA offers a discussion of two possibilities that would achieve this objective in our detailed comments in the Appendix.

- Bifurcation-by-risk: Benchmark Interest Rate: The Exposure Draft could be further improved by expanding the current bifurcation-by-risk approach population to allow hedges of other identifiable and reliably measurable interest rate risk exposures, such as the federal funds rate, the prime rate, and inflation indexes. Such changes would reduce preparers’ concerns with performing the complex “long haul” calculations for cash flow hedges and would achieve convergence with a critical aspect of the IASB’s hedge accounting model.
- Bifurcation-by-risk: Nonfinancial Risk Components: Since the issuance of Statement 133, many companies that have significant exposures to market risks created in the ordinary course of business have been unable to successfully qualify for hedge accounting due to the complexity of the technical requirements. While the Exposure Draft would likely allow more hedges to qualify for hedge accounting and relax certain current demands to qualify for hedge accounting, certain valid and effective hedges would yield significant income statement volatility without the ability to define the hedged risk associated with a nonfinancial contract in a manner which reflects the economic risk being hedged. Accordingly, many commercial companies may find the Exposure Draft of limited benefit unless the FASB were to reconsider the types of risks that can be hedged for accounting purposes. As the IASB has tentatively concluded

through its deliberations that a contractually specified and reliably measurable nonfinancial risk component is a permitted hedged risk, we strongly encourage the FASB to consider incorporating the IASB's final decisions on this point into the final Financial Instruments Accounting Standards Update.

- ISDA strongly disagrees with the proposed change to Topic 815 that will prohibit voluntary dedesignation of a hedge accounting relationship and, further, finds the proposed guidance on effective terminations to be nonoperational and cost prohibitive. The need to voluntarily dedesignate a hedge accounting relationship often stems from the limitations in how a hedged transaction can be defined under current U.S. GAAP. In practice, many companies group related exposures (i.e., net interest exposure resulting from a group of interest-bearing assets and related funding sources) in order to determine what risks should be hedged. Because U.S. GAAP does not allow an entity to hedge on a macro basis (i.e., based on the risk within a portfolio of financial assets and liabilities), but rather at a transaction level, a transaction is selected to represent the total risk exposure for designation purposes. As changes occur in the risk profile of the underlying grouped exposure, companies will commonly add new hedging relationships and remove, or dedesignate, existing hedge relationships. Such risk management strategies are prudent and appropriate. However, we understand that certain FASB Board members may be concerned that income statement geography (i.e., net interest margin) can be managed through hedging strategies that involve active dedesignation and redesignation. ISDA is not aware of any such abuses in current practice and all known hedging strategies that are dynamic (involving active dedesignation and redesignation) are based on risk management objectives, not income statement geography or management of earnings. If the basis of FASB's concerns regarding dedesignation stems from academic studies, we respectfully request that the FASB first validate that such perceived abuses are real and exist. Hedge accounting rules are already too detailed and prescriptive, designed with a heavy focus on precluding many perceived financial reporting abuses. ISDA does not believe it is appropriate to add arbitrary restrictions to the current hedge accounting model (i.e., preclude dedesignations) in order to close nonexistent loopholes. ISDA believes that enhanced disclosure about why companies redesignate or dedesignate hedging relationships is the appropriate way to address the FASB's concern.

Comment Period, Effective Date, and Transition

- ISDA is concerned that the comment period provided within the Exposure Draft will be insufficient for respondents to fully review, analyze and form useful feedback on the amendments given that the full population of changes to the codification has yet to be issued for public review. In many cases, a review of changes to existing accounting standards is necessary to fully comprehend the scope and impact of a major change in an accounting standard, especially in areas that are more complex. We therefore strongly recommend that the Board provide constituents additional time to respond to the Exposure Draft and extend the comment period expiration date to allow for at least 60 days to review the proposed marked changes to the codification when finally issued.
- Given the magnitude of the changes proposed in the Exposure Draft (including the expanded use of fair value as a measurement attribute for financial instruments currently measured at amortized cost), ISDA believes that most preparers in the financial services industry would need at least three to four years to understand, evaluate, and implement the Exposure Draft's provisions and begin including them in audited financial statements.
- ISDA disagrees with the proposed transition guidance for the hedge accounting-related amendments, which would require retrospective application of the proposed changes to hedging

instruments/hedging relationships that were in place prior to and which exist at the date of transition. For example, the process to retrospectively measure the cumulative impact of applying “long haul” hedge accounting to a hedge which previously qualified under the shortcut method will be time consuming for many companies and provide little, if any, benefit to financial statement users. Furthermore, we are unclear how the transition guidance would be applied to hedge relationships that exist as of the initial date of adoption but which were dedesignated and redesignated in periods prior to transition. We believe any requirement to apply the proposed rule that prohibits or restricts dedesignation retrospectively would fail the most basic of cost-benefit tests. Accordingly, we strongly recommend that the final standard require only prospective application of the proposed hedge accounting provisions to qualifying hedge accounting relationships that are designated anew in periods subsequent to the initial date of adoption with no restatement required for hedge accounting relationships reported in periods prior to adoption. All continuing hedge relationships established prior to the effective date would be grandfathered and accounted for under the hedge rules existing at the time of designation until these hedges mature, are terminated or no longer qualify for hedge accounting.

We hope you find ISDA’s comments informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter please do not hesitate to contact the undersigned.



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Appendix

Scope

1. Clarification of In-scope Instruments

The Normal Purchases and Sales exemption which was part of ASC 815 has not been included in the Exposure Draft. It is unclear whether it is the FASB's intention to include within the scope of the Financial Instruments Exposure Draft contracts which currently qualify as normal purchases and sales and no longer permit them to be accounted for under the exemption from fair value accounting. If the FASB intends for these contracts to be included within the scope of the Financial Instruments standard without exemption, we recommend that the marked changes to the codification clarify this question as there is a significant number of over-the-counter commodity contracts which meet the definition of a financial instrument and a derivative (such as those which permit net settlement or are readily convertible to cash), but which currently meet the normal purchases and sales criteria in Topic 815 as physical delivery is anticipated. If the FASB intends to include these types of contracts within the scope of the Exposure Draft and thus require fair value accounting, we recommend that the FASB state this and cite its basis for conclusions.

2. Convertible Debt

Example 10 (paragraphs IG 64 and 65) in the Exposure Draft discusses the accounting for convertible debt by both the issuer and the investor and concludes that because the principal may not be returned to the investor at maturity, a convertible debt instrument must be measured at fair value with changes in fair value recognized in net income. ISDA questions the FASB's decision to address and conclude on the accounting for convertible debt by the issuer given the existence of the FASB's and IASB's separate project on the accounting for Financial Instruments with Characteristics of Equity. ISDA is of the view that the principles for determining the classification and measurement of convertible debt are best suited to be addressed in a comprehensive manner as part of the project intended to address the accounting for all financial instruments with characteristics of equity. Therefore, until the Financial Instruments with Characteristics Equity project is finalized, the FASB should continue to require issuers of convertible debt to continue to analyze these instruments under the scope exception for embedded features that are indexed to a company's own stock and classified in shareholders' equity.

Classification and Measurement

1. Measurement of Core Deposit Liabilities

ISDA does not support the proposed measurement model for core deposit liabilities and concurs with the alternative views cited in the Exposure Draft's basis for conclusions. The proposed measurement approach creates a new measurement attribute that neither represents fair value nor amortized cost. The requirement to apply this measurement both at initial recognition and at subsequent measurement date will require a major undertaking and will create significant operational and financial reporting challenges to even the largest of institutions due to likely changes in an entity's alternative borrowing rate at any point in time (which is largely driven by market interest rates, the size of a funding need, and supply and demand). Additionally, we question the decision by the majority of the Board members to differentiate the measurement attribute to be applied to core deposit liabilities from other deposit liabilities since both instruments have the same (or very similar) economic characteristics. Further, in cases where a financial institution has acquired a group of core deposits in a business combination, the financial

statements of the acquiring entity will report both a core deposit intangible and a core deposit liability, with the liability initially reflecting a portion of the core deposit intangible which results in an unusual financial statement presentation. Accordingly, we question how the proposed measurement model more faithfully reflects the economic characteristics of a core deposit arrangement and provides decision-useful information.

The proposed approach will require management to make significant judgments and assumptions about their own deposit portfolio, many of which would require the use of unobservable and entity-specific data, which will introduce more level 3 measurements into the financial statements. The increased use of entity-specific data when measuring core deposit liabilities will reduce comparability among financial institutions which offer similar deposit arrangements. In light of our views regarding the measurement approach for core deposit liabilities, ISDA strongly recommends that the FASB abandon the proposed measurement approach and permit core deposit liabilities to be measured at amortized cost.

2. Reclassification of Financial Instruments

ISDA does not agree with the FASB's proposal to prohibit reclassification of financial instruments after initial recognition under any circumstances— even if an entity's business model has changed. In certain cases, an entity's business strategy may change especially as markets develop and evolve. As such ISDA, questions the decision not to permit an entity to reclassify a financial instrument that was classified and measured based on a business strategy that has changed since initial recognition but to require a different classification and measurement approach for newly recognized financial instruments with similar characteristics and risks based on the revised business strategy. Consistency in the classification of similar financial instruments managed under the same business strategy would provide more comparable and decision-useful information to financial statement users. Also, while ISDA acknowledges the concerns associated with reclassifying financial instruments under current GAAP, prohibiting reclassification between categories when an entity's business model changes is seemingly inconsistent with the notion that the initial classification of a financial instrument is largely dependent upon an entity's business strategy. Lastly, the prohibition against reclassifications creates greater divergence between IFRS 9 and the FASB's proposed classification and measurement model.

Accordingly we strongly recommend that the FASB require (versus permit) an entity to reclassify recognized financial instruments when its business model has changed and account for those changes in the measurement attribute on a prospective basis. Entities should also be required to provide transparent disclosure of the reasons for the reclassification. If reclassifications are required when an entity's business model changes this would significantly reduce the concerns associated with the existing U.S. GAAP reclassification model and would limit the amount of management judgment involved with determining when a reclassification is appropriate.

3. Presentation of Changes in an Entity's Own Credit

The Exposure Draft requires an entity to present separately on the statement of comprehensive income the amount of significant changes in the fair value of its own financial liabilities attributable to changes in its own credit standing during the reporting period, excluding any changes in the price of credit. While ISDA would support recognizing changes in an entity's own credit risk when measuring financial liabilities at fair value on a recurring basis in other comprehensive income, ISDA strongly disagrees with the proposed methodologies for measuring changes in an entity's own credit standing in Appendix B of the Exposure Draft as it is generally

impractical to isolate changes in an entity's own credit risk from changes in the price of credit in a meaningful way, especially on a recurring basis. The proposal runs counter to how an entity's nonperformance risk is currently measured and evaluated internally and externally and how lending and investment decisions are made. Additionally, the Exposure Draft's proposed approach for measuring changes in an entity's own credit risk was previously considered— but rejected— by the FASB at the time it issued FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*. Paragraphs 14 and 15 of the Basis for Conclusions within Statement 138 state that the Board's decision to amend the definition of interest rate risk (in DIG Issue No. E1) reflected the difficulty of measuring the changes in fair value of the hedged item attributable to changes in credit sector spreads, because consistent sector spread data are not readily available in the market. Paragraph 15 of Statement 138's Basis for Conclusions provides that "The Board decided that, with respect to the separation of interest rate risk and credit risk, the risk of changes in credit sector spread and any credit spread attributable to a specific borrower should be encompassed in credit risk rather than interest rate risk."

Therefore, ISDA questions the basis for overturning the FASB's previous decision on how credit risk should be measured and creating a unique methodology for reporting and presenting changes in an entity's own credit risk in the financial statements. We strongly recommend that this proposed requirement be modified to require separate disclosure of **overall changes** in an entity's own credit risk as described above following the guidance in ASC Topic 820 or for it to be eliminated altogether.

4. Foreign Currency Remeasurement

ISDA strongly objects to the proposal in the Exposure Draft that foreign currency transaction gains/losses on items accounted for at FVTOCI should be recorded in OCI. This is currently a significant difference between U.S. GAAP and IFRS, and we see no reason why the proposals in the ED represent an improvement in financial reporting. We understand that EITF Issue No. 96-15, "Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities," required transaction gains/losses to be recorded in OCI as a practical exception to the key principles in FASB Statement No. 52, *Foreign Currency Translation*, and to relieve certain of the measurement issues raised by holding foreign-currency-denominated debt securities. International Accounting Standard No. 39, *Financial Instruments: Recognition and Measurement*, has always required such transaction gains/losses to be recognized in earnings and provides implementation guidance for measuring those amounts. In our experience, financial institutions have been able to apply the requirements in IAS 39 with little or no difficulty. The proposals in the Exposure Draft would significantly expand the population of financial assets and financial liabilities for which foreign currency transaction gains/losses are not recorded in earnings. In our view, the Board did not adequately address the principles underlying this proposal or the significant and pervasive effect that it will have on reported earnings.

Most financial institutions economically hedge foreign currency risk between their assets and liabilities, whether such assets and liabilities are accounted for at FVTPL, FVTOCI, or amortized cost. It should not be necessary to layer on complex fair value hedge accounting programs to permit foreign currency gains/losses to be reclassified from OCI to earnings. Such hedge programs are required under U.S. GAAP today. For example, financial institutions often hold foreign-currency-denominated available-for-sale (AFS) debt securities that are funded by (and economically hedged with) foreign-currency-denominated debt or deposit liabilities. In order to avoid significant misleading income statement volatility (because transaction gains/losses on the liabilities are recorded in earnings, while offsetting losses/gains on the debt securities are

recorded in OCI), U.S. GAAP requires the application of fair value hedge accounting programs of foreign currency risk on the AFS debt securities. The notional amounts of such hedge programs would increase exponentially under the FASB's proposals, even when a financial institution has foreign-currency-denominated assets and liabilities accounted for at FVTOCI. This is because assets and liabilities will not mature at the same time, resulting in realized gains/losses at maturity of the assets and liabilities being reclassified to earnings in different periods. We believe all such implementation issues could be avoided, U.S. GAAP and IFRS could be converged in this area, and U.S. GAAP could be significantly simplified and improved by having the principle that all foreign currency transaction gains/losses should be recorded in earnings. We request that the Board address this issue in more detail during its redeliberations.

Hedge Accounting

1. Concerns Regarding the Elimination of the Shortcut Method

In the financial services industry's perspective, the shortcut method is the most representationally faithful reflection of the common risk management use of interest rate swaps to "swap the coupon" of fixed rate financial instruments to a floating rate. The income statement under the shortcut method accurately reflects both the floating rate yield and the floating rate debt cash flows. Under the various measurement and basis adjustment amortization methods required by GAAP, the representational faithfulness in the income statement cannot be achieved under the "long haul" method, even if the hedge relationship were to be assessed to have exactly zero ineffectiveness. Most significantly, requiring companies to transition to "long haul" will be costly, will create operational and administrative burdens, will increase volatility in earnings that has no relevance to current or future cash flows or the economic risk intended to be hedged, and will increase the complexity in applying ASC Topic 815. We refer the FASB to the June 2006 ISDA presentation given to certain FASB staff and Board members that illustrated the significant practice issues associated with applying the "long haul" method and that quantitatively demonstrated that the shortcut method is more representationally faithful of the economics and cash flows of a hedging relationship than the "long haul" method. ISDA would be happy to provide the entire Board a copy of this presentation upon request.

Our views regarding the shortcut method notwithstanding, ISDA acknowledges that the elimination of the shortcut method will eliminate preparer concerns regarding the severe consequences of unintentionally misapplying the aforementioned methodology for assessing hedge effectiveness (e.g., with corresponding or attendant risk of financial reporting restatement); however, new concerns and practice issues invariably will arise such as the ability to develop a sustainable and well controlled process to comply with the "long haul" calculations prescribed in Topic 815. In our experience the application of the "long-haul" method does not achieve the Board's goal of simplification—the current "long haul" approach is complex and generally requires the use of valuation and risk management systems in order to carry out its prescribed computations. Additionally, the issues discussed above regarding the income statement results produced by applying the "long haul" method have not been addressed by the Exposure Draft. Given the number and magnitude of changes to Topic 815's hedge accounting provisions proposed in the Exposure Draft, we strongly encourage the FASB to take the opportunity to address the practice issues associated with fair value hedges of interest rate risk and simplify the accounting model. As discussed more fully below we believe certain targeted changes to the Exposure Draft would help address preparer concerns in this area.

Under paragraphs 81 and 81A of IAS 39, *Financial Instruments: Recognition and Measurement*, and pursuant to the IASB's tentative conclusions reached as part of its deliberations on its hedge

accounting project, a preparer is permitted to define the hedged item as a portion of the cash flows or fair value of a financial asset or financial liability (herein referred to as “financial instruments”)². ISDA finds that the ability to hedge a portion of a financial instrument’s cash flows or fair value would address the practice issues associated with applying the “long haul” method and, at the same time, would more faithfully reflect the economic risk intended to be hedged. While an entity that defines a portion of a financial instrument’s cash flow or fair value as the hedged item (under IAS 39) may easily qualify for hedge accounting, an entity is still required to measure ineffectiveness. This requirement, if introduced to the U.S. GAAP hedge accounting model, would alleviate the FASB’s concerns with companies assuming that a hedge has no ineffectiveness. The ability to hedge a portion of a financial instrument’s cash flow or fair value has existed since IAS 39’s original issuance and has been commonly interpreted and consistently applied in practice. Accordingly, we believe that the incorporation of IAS 39’s portions approach for financial instruments within the Exposure Draft would strike an appropriate balance between simplification and representational faithfulness and would achieve further convergence between U.S. GAAP and IFRS in this area. ISDA therefore recommends that the FASB modify the Exposure Draft to provide companies the ability to define the hedged item in a fair value or cash flow hedge as all *or a separately identifiable and measurable portion* of a financial asset or liability’s cash flows or fair value.

If the FASB decides not to incorporate the ability to hedge a separately identifiable and measurable portion of a financial asset or liability’s cash flows or fair value into its amendments to ASC Topic 815 we recommend that the current methodology for measuring ineffectiveness in a fair value hedge of a financial asset or liability under the “long haul” method be simplified and converged with the existing ineffectiveness measurement methodology for cash flow hedges in order to alleviate the concerns regarding operationality (i.e., transitioning from shortcut to “long haul”). ISDA is of the view that a hedge that converts a fixed rate financial instrument to a floating rate achieves a similar business objective as a cash flow hedge that converts a floating rate financial instrument to a fixed rate—both hedges aim to change the cash flow profile of the financial instrument. As such, we believe that the measurement of ineffectiveness for a fair value hedge of interest rate risk should follow the same principles as the current model for measuring ineffectiveness associated with a cash flow hedge of interest rate risk (i.e., using a hypothetical derivative approach). This would increase comparability in the reporting of instruments with similar risk characteristics and similar hedged risks and would greatly reduce complexity in the accounting for and reporting of all hedges of interest rate risk.

2. Bifurcation-by-Risk – Benchmark Interest Rate

ASC Topic 815 currently limits the type of interest rate risk that can be separately hedged to a benchmark interest rate (which is defined in the United States capital markets as either the rate on U.S. Treasury obligations or the LIBOR swap rate). Companies commonly hedge cash flow interest rate risk exposures that, in many cases, do not qualify as a benchmark interest rate as defined in ASC Topic 815 (for example, the federal funds rate and prime rate-based financial instruments). This has become even more of an issue in the recent economic cycle in which many nonbenchmark-based loans were originated with terms that provide for an increase in the credit spread above the contractual interest rate index based on changes in a borrower’s own credit risk profile (e.g., credit rating). As such, companies that have effectively eliminated the interest rate risk to which they are exposed are often burdened with measuring and reporting ineffectiveness with respect to credit risk (hedges of total cash flows) which does not faithfully reflect the desired economic hedge relationship. In order to make the current U.S. GAAP hedge

² The portion of the cash flow or fair value must be identifiable and measurable.

accounting model more useful and relevant and to achieve a greater degree of convergence with current IFRS (as well as the IASB's tentative decisions reached under its hedge accounting project), ISDA strongly recommends that the FASB reconsider its bifurcation-by-risk approach and broaden its application to permit other well accepted, separately identifiable and reliably measurable interest rate indexes to be eligible hedged risks.

Entities have responsibly hedged the benchmark interest rate under U.S. GAAP since Statement 138's issuance; likewise, entities that report under IFRS have responsibly hedged other separately identifiable and reliably measurable financial risks. Such hedges have not been the subject of interpretational issues under either of the financial reporting frameworks. Further, we understand that one factor considered by the FASB in its decision to permit the hedge of a benchmark interest rate under Statement 138 was the ability to objectively separate credit risk from the benchmark interest rate component (the FASB also considered the liquidity and stability of LIBOR). Similarly, the FASB's decision in DIG Issue No. G26 on when the interest payments associated with a variable rate asset or liability would qualify for a hedge of a benchmark interest rate was predicated on the "transparent separation of interest rate and credit risk." In most cases, the indexes companies attempt to hedge are clearly distinct from the credit risk of the debt instrument. Since many of the common interest rate indexes used to determine interest on debt instruments in the market are just as liquid and stable as LIBOR, expanding the ability to hedge separately identifiable and reliably measurable interest rate risks beyond the benchmark interest rate risks defined in ASC Topic 815 would not undermine the FASB's original basis for allowing a hedge of a benchmark interest rate under Statement 138. To this end, the Exposure Draft should be modified to expand the current bifurcation-by-risk approach to allow companies to designate other common interest rate-related risk exposures as the hedged risk such as the federal funds rate, the prime rate, the commercial paper rate, or inflation.

3. Bifurcation-by-Risk – Nonfinancial Risk Components

Since the issuance of Statement 133, many companies that have significant exposures to market risks created in the ordinary course of business have been unable to qualify successfully for hedge accounting and have asked the FASB to consider broadening the definition of a permitted hedged item to accommodate certain nonfinancial risk components. In many cases, the ability to qualify for hedge accounting is a significant factor in determining whether a company will execute a hedge. While the Exposure Draft would likely allow more hedges to qualify for hedge accounting, certain valid and effective hedges would yield significant income statement volatility without the ability to define the hedged risk associated with a nonfinancial contract in a manner that reflects the economic risk being hedged and the available hedging instruments. Accordingly, many commercial companies may find the Exposure Draft of limited benefit unless the FASB were to reconsider the types of risks that can be hedged for accounting purposes.

We find the basis for conclusions in Statement 133 regarding the inability to predict and separately measure the effect of a change in a component or variable inherent in a nonfinancial contract to be a broad generalization. The terms of many commercial contracts explicitly provide for payment based on an observable index which can be verified to market data. For example, many commercial freight carriers charge a customer based on actual miles driven plus an explicit fuel surcharge determined based on the actual miles driven times the weekly average on the road diesel price/gallon quoted by the Department of Energy's Retail On-Highway Diesel Prices (the grade of fuel would generally be specified). In this example, the actual economic exposure to the customer is observable and reliably measurable and, therefore, we believe that the hedge accounting model should be amended to allow companies to define a nonfinancial risk component as the hedged risk. In order to eliminate the concerns of misapplication of this

approach in practice, the FASB could define a nonfinancial component based on specific criteria, such as a risk that is contractual, observable, and reliably measurable.

Additionally, since the IASB has found merit in permitting bifurcation-by-risk for nonfinancial risk components, we strongly encourage the FASB to continue to monitor the progress made and decisions reached by the IASB in its hedge accounting project in order to achieve convergence in this important area.

Lastly, we strongly encourage the FASB to address in the final standard a common practice issue concerning the level of aggregation (and homogeneity of risk) permitted when hedging nonfinancial items in a cash flow hedge. Companies that operate in different geographies often have exposure to fungible or highly similar economic risks (e.g., natural gas, unleaded gasoline, copper, etc.); however, because U.S. GAAP requires an entity to hedge the overall variability in total cash flows when the hedged item is nonfinancial, entities must evaluate the potential variability in the overall price of a commodity (i.e., total cash outflows) based on its intended condition and location of use. In cases where a single derivative hedging instrument is used to hedge a group of fungible or highly similar nonfinancial transactions that occur in different geographic locations, there are instances where certain practitioners have required the homogeneity test that was designed for interest rate hedges, while other practitioners have rejected altogether the aggregation of nonfinancial transactions from more than one geographical location.

4. Assessment of Hedge Effectiveness/Reasonably Effective Criterion

ISDA supports the FASB's relaxation of the qualifying criteria for applying hedge accounting, and in conjunction with the guidance in paragraph 118, believes this new approach will ease the burden associated with applying the current hedge accounting model. While we support the elimination of the existing bright line that has been applied under the current hedge accounting model, ISDA is concerned that the current drafting of the proposed revisions to the hedge effectiveness criteria in paragraph 118 of the Exposure Draft (and paragraph BC 217 of the Basis for Conclusions) coupled with the evolution of hedge accounting practices under Statement 133 (as amended) will lead to auditors and regulators creating their own perceptions about when a qualitative assessment of hedge effectiveness is permitted (versus when a quantitative assessment is required), which will only lead to more diversity and complexity in applying the proposed rules. We strongly encourage the FASB to incorporate clear and understandable principles into the final guidance that will aid preparers and auditors in ascertaining the conditions for when 1) a hedge can be regarded as reasonably effective and 2) a qualitative versus a quantitative assessment of hedge effectiveness is required. Accordingly, we strongly recommend that the following modifications to the Exposure Draft be made [Text added is underlined and text deleted is ~~stricken~~].

113. The qualifying criteria for designating a hedging relationship requires that the hedging relationship, at its inception and on an ongoing basis, is expected to be reasonably effective (rather than highly effective) in achieving offsetting changes in fair values or cash flows attributable to the hedged risk during the period of the hedging relationship. The risk management objective expected to be achieved by the hedging relationship and how the hedging instrument is expected to manage the risk or risks inherent in the hedged item or forecasted transaction shall be documented. ~~For most relationships,~~ Compliance with the reasonably effective criterion can be ~~is~~ demonstrated by a qualitative (rather than quantitative) assessment that establishes that an economic relationship exists between the hedging instrument and either the hedged item in a fair

~~value hedge or the hedged transaction in a cash flow hedge. A quantitative assessment may be necessary but such an assessment is not required. Whether a quantitative assessment of hedge effectiveness is necessary requires judgment and depends on the facts and circumstances. is necessary if a qualitative assessment cannot establish compliance with the reasonably effective criterion.~~

BC217. The proposed guidance would require that a hedging relationship be reasonably effective. It also would permit a qualitative assessment of the hedging relationship's effectiveness at inception of the hedging relationship. ~~In certain situations, a~~ quantitative assessment may be necessary at the inception of a hedging relationship to demonstrate that changes in fair value of the hedging instrument are expected to be reasonably effective in offsetting changes in fair value of the hedged item or variability in cash flows of the hedged transaction, but such an assessment is not required.

Lastly, the marked changes to the codification should include amendments to the existing homogeneity criteria in ASC Topic 815 (subsections 820-20-25-12(b)(1) and 820-20-55-14) so that its existing threshold for determining whether similar risks designated in a fair value hedge can be grouped together is reduced from "highly effective" to "reasonably effective" which would align the homogeneity criteria with the hedge qualification requirements.

5. Basis for Hedge Effectiveness

Paragraph BC220 of the Exposure Draft provides the following basis for not defining *reasonably effective*.

"BC220. The Board decided not to define *reasonably effective* for purposes of determining when hedge accounting could be applied and when it could not be applied. The Board believes that it is necessary to use judgment when determining whether a hedging relationship is reasonably effective. That judgment should include a holistic consideration of all the facts and circumstances that led an entity to enter into a hedging relationship. That would include, for example, consideration of **whether the objective of applying hedge accounting was to compensate for accounting anomalies or to achieve a fair value measurement option for items not currently eligible for fair value measurement.**"

ISDA finds the last sentence in paragraph BC220 (in bold text above) perplexing, as we perceive the effectiveness of a hedge relationship to be solely an economic test. We do not understand what the objective for entering into a hedge relationship has to do with whether the hedging relationship is reasonably effective. We further do not believe that the thresholds for an economic test should differ based on the objective for applying hedge accounting.

In addition, ISDA does not understand what is meant by "accounting anomalies" and is concerned about the suggestion of inappropriate objectives where a company appropriately utilizes the hedge accounting requirements for a valid economic hedge relationship. We do not see how applying hedge accounting would achieve the objective of achieving the fair value option given that (1) the extensive criteria required to qualify for hedge accounting and (2) in many cases, the accounting measurements are different in hedge accounting versus the fair value option. In summary, we do not believe an additional criterion to consider the purpose of a hedge is necessary or justified and expect such a requirement to result in unintended consequences. Therefore, ISDA recommends that the final two sentences in paragraph BC220 be struck in their entirety from a final standard.

6. Reassessment of Hedge Effectiveness

ISDA supports the Board's decision to continue to require a reassessment of hedge effectiveness subsequent to inception if circumstances suggest that the hedging relationship may no longer be reasonably effective; however, we strongly recommend that the FASB limit the circumstances that would necessitate a reassessment of hedge effectiveness. Because companies are required to assess hedge effectiveness at the inception of the hedge in order to apply hedge accounting in the first place, and because most hedges are designed to match the key terms of the hedged transaction, we recommend that a subsequent reevaluation of hedge effectiveness only be required if any of the critical terms of either the hedging instrument or the hedged item change during the life of the hedge. We believe that this clarification will alleviate the number of differing interpretations that may arise regarding the circumstances that would require a subsequent evaluation of hedge effectiveness. Accordingly, we recommend that the following modifications to the Exposure Draft be included in the final standard (text inserted is underlined and text deleted is ~~struck~~).

117. After inception of the hedging relationship, an entity shall qualitatively (or quantitatively, if necessary) reassess effectiveness only if the critical terms of either the (a) hedged item or (b) hedging instrument have changed (including changes in the credit standing of the counterparty such that it is no longer probable that it will perform under its obligations) and circumstances therefore suggest that the hedging relationship may no longer be reasonably effective in offsetting.

7. Dedicating of a Hedging Instrument

General

Paragraphs 119 and 120 of the Exposure Draft describe the conditions for when a hedge accounting relationship must be terminated and also provide that an entity may not voluntarily dedesignate a hedge accounting relationship. The basis for the FASB's conclusions that prohibits companies from removing the designation of an accounting hedge states that, "Because the economics of the relationship between the hedging instrument and hedged item (forecasted transaction) have not changed, the Board believes that the accounting should not change. The Board acknowledges that an entity could override the special accounting under fair value and cash flow hedges by terminating the derivative designated as the hedging instrument and entering into a similar new derivative, which action involves actual economic transactions. However, the Board does not believe that arbitrary dedesignation (which does not involve actual economic transactions) should be used as a tool for changing measurement attributes and/or managing the classification of certain items reported in net income."

ISDA notes that companies have different levels of risk depending on the nature of their activities, and accordingly, hedge their risks differently. For example, certain companies hedge the risk to which they are exposed because of discrete transactions. However, risk management is often not based on exposures resulting from specific transactions. Rather, many companies group related exposures (i.e., net interest exposure resulting from a group of interest-bearing assets and related funding sources) in order to determine what risks should be hedged. Because U.S. GAAP does not allow an entity to hedge on a macro basis (i.e., based on the risk within a portfolio of financial assets and liabilities), but rather only at a transaction level, a transaction is selected to represent the total risk exposure for designation purposes. As changes occur in the risk profile of

the underlying grouped exposure, companies will commonly add new hedging relationships and remove, or dedesignate, existing hedge relationships. Because such risk management strategies are prudent and appropriate, we find the FASB's basis for conclusions regarding dedesignation to be flawed and inaccurate. In ISDA's view, the proposed conditions for a permissible dedesignation are unnecessarily restrictive. Entering into an offsetting derivative is a costly and unnecessary expense when the existing derivative may be reused and possibly redesignated for other purposes including risk management in a qualifying hedge accounting relationship. Terminating a derivative may also have significant negative liquidity impacts as a result of having to settle a derivative payable prior to scheduled maturity. This dedesignation restriction will likely complicate or prohibit such common hedge strategies as (1) "dynamic" or "delta-hedging" strategies from qualifying under a benchmark interest rate risk and other designations; (2) the ability to dedesignate hedges of foreign currency sales/purchases upon recognition of the resulting receivables/payables to be remeasured under SFAS 52, *Foreign Currency Translation*; (3) fair value hedges of commodity inventory balances that change over time. We are not aware of any perceived lack of clarity or diversity in practice in this area; accordingly, it is unclear why the FASB is focusing on this aspect of the hedge accounting model. Additionally, ISDA does not understand what types of hedge accounting relationships referenced in paragraph BC223 of the basis for conclusions the FASB believes would not be impacted by the decision to not permit voluntary dedesignation. We strongly suggest that the FASB more clearly articulate its rationale by citing specific examples of how existing hedge accounting strategies that involve voluntary dedesignation could continue under the proposed model.

The FASB's basis for not permitting voluntary dedesignation while at the same time acknowledging that an entity can achieve a result similar to dedesignating a hedge by terminating the hedging instrument or entering into an offsetting derivative runs counter to the premise that the initial application of hedge accounting is voluntary. Since hedge accounting continues to be elective and thus can be applied after a derivative is initially transacted, we do not believe that the proposed rule on dedesignation will improve financial reporting. Additionally, as the economic and financial reporting outcome of a hedge dedesignation can often be achieved by either terminating a hedging instrument or entering into an offsetting transaction we do not understand the FASB's basis for differentiating between methods for managing changes in an entity's risk profile. Therefore, we strongly recommend the FASB reconsider its decision to prohibit dedesignation before a hedge expires, and further reconsider the resulting consequences. We also ask the FASB to clarify users' concerns with a company's decision to end a hedging relationship early when, in fact, the changes in fair value of the hedging instrument are subsequently included in earnings. If users find complexity in understanding when a dedesignation has occurred, the hedged items impacted and the future effects of the hedged item on earnings, we suggest that the FASB address these concerns through enhanced financial statement disclosures rather than by restricting hedge accounting for prudent and cost-effective risk management practices.

Lastly, because the proposed amendment regarding dedesignation is such a significant change to current practice, we also recommend that the FASB cite in the body of the standard that a derivative designated in a hedge relationship that subsequently fails to meet one the criteria set forth in paragraphs 28 or 29 of Statement 133 can be redesignated in a new qualifying hedge relationship.

Effective Terminations

We understand the FASB's intention with respect to the proposed guidance on effective terminations is to require an entity to economically settle an existing derivative designated in a qualifying hedge accounting relationship. We perceive that preparers will find this guidance of little benefit as companies or their derivative counterparties will be unable to execute an identical derivative that fully offsets future changes in the fair value or cash flows of the original derivative due to a variety of limitations (including credit risk and liquidity concerns).

Current practice for effectively terminating a derivative that was part of a dedesignated hedge accounting relationship typically involves entering into an offsetting zero fair value derivative that is at-market with either the same or a different counterparty that offsets the market risk associated with the original derivative going forward and in combination crystallizes the gain or loss on the original derivative. The proposed conditions that would allow an effective hedge accounting relationship to be terminated without actually settling the derivative would require an entity to enter into an off-market derivative with offsetting (mirror image) terms. The proposed requirements for effectively terminating a hedging derivative require future changes in fair value to be fully offset, which could be interpreted as requiring the new off-market derivative to be executed with the same counterparty (or one with the identical credit risk). In order to consummate such a transaction, an entity or its counterparty would need to make a payment at inception which is not always prudent or possible depending on the amount of financing involved. Further, in many cases the credit risk policies of the parties to a derivative may preclude it from executing an offsetting derivative with the same counterparty. Many banks have policies that either restrict or preclude entering into off-market derivative transactions with clients. Thus, many companies may be unable to enter into offsetting off-market derivatives in order to terminate a hedge from an accounting perspective.

Moreover, ISDA finds the provisions that would preclude the original hedging derivative and the new offsetting derivative to be redesignated in a new hedge accounting relationship for their remaining lives burdensome and nonoperational. Our primary concern with this proposal is that companies seeking to manage risk prudently will be forced to execute additional derivative transactions when additional risk exposures arise. We fail to see how this passes the most basic of cost-benefit tests. Additionally, companies, which are party to a large number of derivatives and find it necessary to terminate a hedge relationship by entering into an offsetting derivative, would be tasked with creating and tracking new information that allows the entity to identify derivatives that are no longer eligible for hedge accounting relationships for a prolonged period of time. This will require significant modifications to transaction systems infrastructure and additional monitoring and is further exacerbated when applied to a hedging instrument composed of multiple derivatives.

If the FASB decides to retain the proposed prohibition on voluntary dedesignation, we strongly recommend that the criteria for effective terminations allow for entity to enter into an at-market derivative that offsets the market risk associated with the original derivative in order to make execution of a prudent risk management technique more operational and cost effective. Additionally, we strongly recommend that the FASB eliminate the proposed restrictions on the subsequent designation of a derivative that is effectively terminated and the offsetting derivative in a hedge accounting relationship at a later date.

Net Investment Hedges

The Exposure Draft does not address how to change the notional amount of the hedging instrument(s) as the amount of the current net investment changes over time given the inability to dedesignate/redesignate. Because net investment hedges are neither fair value hedges nor cash flow hedges and because DIG Issue H7 will be superseded, the final standard should be modified to allow dedesignation and redesignation of net investment hedges. ISDA believes that the retention of the guidance in DIG Issue H7 is necessary in order to address how to change the hedged amount as the amount of an entity's net investment in a foreign operation changes.

8. Macro Hedging

Companies exposed to interest rate risk in both their investment portfolios and liabilities often manage this risk on a portfolio or macro basis. Under current U.S. GAAP, entities are not permitted to designate the combination of financial instruments as a single hedged item unless those individual instruments are expected to respond similarly to changes in the hedged risk. Further, U.S. GAAP prohibits aggregating a combination of financial assets and financial liabilities to be a hedged item. Therefore, companies looking to hedge their net interest rate risk exposure are required to define the hedged item as either an individual asset or liability (or groups of similar assets or liabilities) which often requires frequent dedesignation/redesignation of the hedge relationship as the net risk exposure within the portfolio changes. This issue is significant for financial services companies that generally manage interest rate mismatches between investments acquired or loans made and their short and long-term obligations through the use of interest rate derivatives that are designated in "dynamic" hedges. The ability to hedge on a macro basis would alleviate many of the issues associated with the FASB's proposal that would prohibit voluntary dedesignation of a hedge accounting relationship.

The IASB has tentatively decided under its hedge accounting project to expand the existing macro hedging approach in IAS 39 by changing how the hedged item can be defined in a macro hedge. The tentative decisions of the IASB would permit the hedged item to include a net exposure comprising financial assets and liabilities and derivatives which may ease the burden associated with hedging a company's net interest rate exposure. We are disappointed by the lack of any deliberation regarding the merits of "macro hedging" under the FASB's Financial Instruments project given this is such a core issue for a significant number of entities within the financial services sector. Therefore, we encourage the FASB to monitor the IASB's decisions in this area for possible inclusion in the final standard on hedge accounting. In the interest of convergence and reducing complexity we encourage the Board to include guidance on the application of "macro hedges" in the final standard.

9. Changes in a Hedging Instrument

Paragraph 121 of the Exposure Draft provides that an entity may modify a hedging instrument by adding a derivative to the existing hedging relationship that would not offset fully the existing hedging derivative and would not reduce the effectiveness of the hedging relationship. The Exposure Draft further provides that such modification would not result in the termination of the hedging relationship (although the documentation for the hedging relationship would need to be updated). While we find the ability to modify a hedging instrument designated in an existing hedging relationship without requiring dedesignation as an improvement to the existing hedge accounting model, we question why the FASB has decided not to permit an entity to reduce the size (or number) of derivatives designated in a hedge accounting relationship, if doing so

maintains or increases the degree to which a hedge is deemed reasonably effective. As the addition of new derivatives invariably increases counterparty credit risk, we find the decision to allow entities only to add to an existing hedging instrument arbitrary and lacking merit. ISDA therefore recommends that the FASB permit an entity to reduce the size or number of derivatives without disrupting a hedge accounting relationship, if doing so maintains or increases the degree to which the hedge accounting relationship is deemed to be reasonably effective.

Additionally, the final standard should address the existing diversity in practice regarding the impact a change in the legal counterparty to the derivative (e.g., a novation of the contract from one counterparty to another) has on a hedge accounting relationship. Some practitioners hold the view that a change to the counterparty with no changes to any of the derivative's economic terms does not disrupt the original hedge relationship, while others view such a change as an event that requires dedesignation. Therefore, we recommend that the FASB explicitly state in the final standard that a change in the counterparty to a derivative does not, in and of itself, require termination of an existing hedge accounting relationship.

10. Measurement of Ineffectiveness – Cash Flow Hedges

Paragraph 122 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.”

The FASB's proposed requirement to use a derivative that exactly offsets the hedged cash flows, while simultaneously removing guidance that assists in defining the terms of the hypothetical derivative, adds significant complexity and uncertainty into the hedge accounting model. DIG Issue No. G7 currently allows preparers to use the “hypothetical derivative method” to measure hedge ineffectiveness and also provides guidance on how to determine what the terms of a “hypothetically perfect” derivative should be. DIG Issue No. G7 refers constituents to paragraph 68 of Statement 133 and indicates that the “hypothetical derivative would need to satisfy all of the applicable conditions in paragraph 68 (as amended)...” which would result in a hypothetical swap that would be expected to exactly offset the cash flows. This reference to paragraph 68 makes the hypothetical derivative method of DIG Issue No. G7 operable in practice, because it does not require the hypothetical derivative to be the hedge that exactly offsets the hedged cash flows, but rather to be the “pragmatically perfect” hedge, based on the alignment of the critical terms.

ISDA recommends that the FASB retain guidance in the codification to define the terms of the Exposure Draft's version of the hypothetical derivative, such as the concept of “critical terms” as explained in paragraph 65 of Statement 133. Requiring that the derivative used to measure ineffectiveness match the critical terms of the hedged transaction would provide sufficient guidance for preparers to use this proposed method in practice. Should the FASB choose to use a critical terms concept, we recommend that the FASB emphasize the need to match only the critical terms and not the non-critical terms, so as to avoid the reinterpretation and restatement issues that have occurred with paragraph 68. If the FASB chooses not to incorporate our recommendations we strongly urge that it provide factors to consider when constructing a derivative that provides cash flows that would exactly offset the hedged item and clarify whether this derivative must have a zero fair value at the inception of the hedge accounting relationship.

Additionally, paragraph 122 of the Exposure Draft could be interpreted such that the derivative to be constructed 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 a particular date in the life cycle of a hedged item on which the actual cash flows to be paid or received are contractually fixed, such as the reset date on a variable rate debt instrument or the date on which a foreign-currency-denominated transaction (subject to remeasurement under SFAS 52) is initially recognized in the statement of financial position. For example, many companies hedge to the date on which a foreign-currency-denominated sale is initially recorded rather than the collection date of the receivable, when the actual cash flow occurs. We believe that an on-market derivative that is entered into at the inception of the hedge and settles on the sale date (when there is no cash flow exchange in respect of the hedged transaction, but the variability of the foreign currency of the sale transaction ends) should result in zero ineffectiveness if the hedge is matched to the terms of the sale even though there is no actual cash flow at the date of sale. Thus, we strongly recommend the FASB amend paragraph 122 so that the final standard permits companies to define the derivative that exactly offsets the variability of the hedged cash flows (e.g., the reset/repricing risk), not offset the hedged cash flows themselves.

11. Recognition of Ineffectiveness in Net Income – Cash Flow Hedges

Paragraph 123 of the Exposure Draft provides that, “An entity shall adjust accumulated other comprehensive income associated with the hedged transaction to a balance that reflects the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the amount previously reclassified from accumulated other comprehensive income into net income, if any. Thus, ineffectiveness is recognized for both overhedges and underhedges.” The basis for the FASB’s decision to require both under-hedging and over-hedging in earnings states that, “The Board also believes that in those situations there should be no distinction between whether the change in value of the actual derivative is greater than or less than the change in value of a derivative that would mature on the date of the forecasted transaction and provide cash flows that would exactly offset the hedged cash flows.” Further, the basis for the FASB’s decision states, “The Board believes it is preferable to treat overhedges and underhedges consistently.”

The FASB’s Basis for conclusions does not address why this fundamental change from Statement 133 is an improvement to financial reporting or results in simplification, and further does not address the change in the conclusion the FASB reached when it issued Statement 133. In paragraphs 379 and 380 of Statement 133 the FASB explained its decision to prohibit recognition in other comprehensive income of *nonexistent* gains or losses relating to the change in present value of the cash flows associated with non-contractual, forecasted transactions. We support the prior Board’s rationale for limiting recognition of ineffectiveness in earnings to amounts by which the actual derivative instrument exceeds, on an absolute basis, the projected present value of the hedged cash flows. Therefore, ISDA does not agree that such a significant change to Statement 133 should be made without a more robust justification that directly addresses how reporting these noncontractual gains and losses in OCI and earnings provides more transparent financial statements, and achieves the appropriate cost-benefit conclusion. Moreover, retention of the current approach for recognizing ineffectiveness associated with a cash flow hedge would achieve convergence between the U.S. GAAP and the IASB’s tentative decisions reached under its hedge accounting project on this issue.

12. Hedge Documentation

The precision with which hedge documentation is prepared has been the subject of great interpretation and historically has led to many restatements. In light of the FASB's objectives to simply the hedge accounting model we strongly recommend that the Exposure Draft explicitly state that amplifications to a company's existing hedge accounting documentation that clarify management's original intent should not be treated as a termination of an existing hedge relationship. We then recommend that the final standard include the following examples of alterations to hedge documentation that do not disrupt the original hedge relationship.

- A change to the quantity or volume being hedged (related to the proposed ability to change the notional amount of the hedging instrument in paragraph 121 of the Exposure Draft),
- A change to the date(s) within a period over which a group of hedged transactions are expected to occur,
- Enhancements to the method by which an entity assesses whether a hedge accounting relationship is reasonably effective, and
- Enhancements to the method by which an entity measures ineffectiveness.

13. Hedging with Options

The Exposure Draft continues to permit an entity to include the time value element of a purchased option in the assessment/measurement of hedge effectiveness, but proposes that the time value be recognized in earnings on a rational basis. While we believe this proposal is intended to simplify the accounting for purchased options, it is unclear what is meant by "rational basis." Under DIG Issue No. G20, if an entity chooses to base its assessment of hedge effectiveness on total changes in an option's fair value, the time value element is recognized in earnings when the hedged item affects earnings. The approach for recognizing the cost of a purchased option described in paragraph 125 of the Exposure Draft requires further clarification as to whether the existing recognition model in DIG Issue No. G20 would be an acceptable method under the new rules or whether a different approach will be required (e.g., straight line over the life of the hedge). As such, the final standard should explicitly state that a rational method of amortization includes a linear approach as well as the methodology described in DIG Issue No. G20.

Comment Period, Effective Date, and Transition

1. Comment Period

ISDA is concerned that the comment period provided in the Exposure Draft will be insufficient for respondents to fully review, analyze and form useful feedback on the amendments given that the full population of changes to the codification has yet to be issued for public review. In many cases, a review of changes to existing accounting standards is necessary to fully comprehend the scope and impact of a major change in an accounting standard, especially in areas that are more complex. We therefore strongly recommend that the Board provide constituents additional time to respond to the Exposure Draft and extend the comment period expiration date to allow for at least 60 days to review the proposed marked changes to the codification when finally issued.

2. Effective Date

Given the magnitude of the changes proposed in the Exposure Draft (including the expanded use of fair value as a measurement attribute for financial instruments currently measured at amortized cost), ISDA believes that most preparers in the financial services industry would need at least

three to four years to understand, evaluate, and implement the Exposure Draft's provisions and begin including them in audited financial statements.

3. Transition Provisions

The transition section of the Exposure Draft provides that in the initial fiscal period in which the proposed guidance is adopted, "An entity shall apply the proposed guidance by means of a cumulative effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date. The statement of financial position for that reporting period shall be restated in the first set of financial statements issued after the effective date."

ISDA disagrees with the proposed transition guidance for the hedge accounting-related amendments which would require retrospective application of the proposed changes to hedges that were in place prior to and which exist at the date of transition. As the method of assessing and measuring hedge effectiveness for shortcut hedges that were in place prior to transition and which exist as of the date of adoption will be eliminated, the proposed transition guidance would force companies to assess and measure hedge effectiveness for historical periods for which information may be difficult or impractical to obtain. Furthermore, we are unclear how the transition guidance would be applied to hedge relationships that exist as of the initial date of adoption, but which were dedesignated and redesignated in periods prior to transition, and have concerns that applying the proposed changes that prohibit or restrict dedesignation retrospectively will be operationally impossible. Accordingly, we strongly recommend that the final standard only require prospective application of the proposed hedge accounting provisions to qualifying hedge accounting relationships that are designated anew in periods subsequent to the initial date of adoption with no restatement required for hedge accounting relationships reported in periods prior to adoption.

The transition guidance should also clarify that the new guidance need not be applied to (i) derivative hedging instruments that were part of qualifying hedge relationships and terminated prior to the initial date of adoption and (ii) derivative hedging instruments that are settled or terminated prior to transition (consistent with DIG Issue No. J2) as the cost of recasting opening retained earnings for these transactions and instruments would not outweigh the benefits derived.