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19<sup>th</sup> September 2008

International Accounting Standards Board  
1<sup>st</sup> Floor  
30 Cannon Street  
London  
EC4M 6XH

**Ref.: Discussion Paper (DP) on “Reducing Complexity in Reporting Financial Instruments”**

Dear Sirs,

The European and North American Accounting Policy Committees of the International Swaps and Derivatives Association (“ISDA”) are pleased to jointly provide the following comments with respect to the above mentioned DP issued by the International Accounting Standards Board (“IASB”). Our members have taken a keen interest in this project from the outset, and we have been discussing the long term objectives for simplifying and improving accounting for financial instruments since its inception.

ISDA has over 840 member institutions from 56 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. As such, we believe that ISDA brings a unique and broad perspective to the work of the IASB and FASB.

Many preparers, auditors and users of financial statements find the requirements for reporting financial instruments complex. We therefore strongly support the objective of the IASB and FASB to develop new standards for the reporting of financial instruments that are principles based and less complex than today's standards. In this letter we outline our key messages in response to the Discussion Paper, and we provide in Appendix No. 1, our more detailed responses to the questions included in the Discussion Paper.

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**Key Messages:**

- ISDA believes that fair value measurement is the most appropriate measurement basis for many financial instruments, in particular those held for trading or managed on a fair value basis. However, where an entity is holding the instrument to benefit from its long term cash-flows, the majority of our members believe a cost based measure is more appropriate and are opposed to the longer term objective of measuring all financial instruments at fair value. This view is not shared by all members, but we would recommend that the Board focus its efforts on simplifying the current mixed measurement model rather than its proposed longer term objective.
- ISDA strongly believes that there is an opportunity to simplify some of the current accounting literature relating to classification and measurement of financial instruments. By their nature, financial instruments are often complex and therefore there will always be a degree of complexity inherent in financial instrument accounting standards. However, in our view, many of the current issues arise as a result of the unnecessarily complex accounting rules within extant standards on financial instruments contained within both US GAAP and IFRS. We would therefore encourage the IASB and FASB to focus their efforts on striking a better balance between rules and principles to reduce complexity in financial reporting and simplify the current measurement model.
- Hedge accounting provides a valuable tool for financial statement preparers to communicate to financial statement readers how a business manages the various financial risks it is exposed to. ISDA supports the Board's objective of reducing some of the complexities associated with hedge accounting though it will be critical that any amendments do not restrict the use of some of the most simple and effective hedging strategies that are used in practice. In particular, it is important that entities retain the ability to partial hedge a financial instrument for specific risks. The majority of our members would also encourage the IASB to explore further our proposals to modify fair value hedge accounting to allow the effective portion of a fair value hedge relationship to be recorded in equity. In our view, this may assist financial statement users as it would remove the existing hybrid measurement model. Further, we would encourage the Board to replace the notion of "highly effective" to allow hedge accounting for "reasonably effective" hedging relationships and simplify the current rules to assess hedge effectiveness. We have expressed these views in more detail in our recent comment letter to the FASB on "Accounting for Hedging Activities, an amendment to FAS 133" and we strongly believe that collectively these proposed changes would both simplify and reduce the operational burden of using hedge accounting. Appendix No. 2, includes a copy of this letter. It will be important for the Board to gauge the thoughts and comments of analysts and other users as the project develops. To help facilitate further convergence with US GAAP, we would encourage the IASB to work with the FASB on the medium term objective of amending aspects of financial instrument accounting.


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



Laurin Smith  
*J.P. Morgan Chase & Co.*  
Chair, North America Accounting Policy  
Committee



Melissa Allen  
*Credit Suisse*  
Chair, European Accounting Policy  
Committee



Antonio Corbi  
International Swap and Derivatives Association  
Risk and Reporting

**Attachments:**

**Appendix No. 1 – Responses to specific questions raised by the IASB**

**Appendix No. 2 – ISDA response to the FASB on “Accounting for hedging activities, an amendment to FAS 133”**

## **Appendix No. 1 – Responses to specific questions raised by the IASB**

### **Question 1**

*Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?*

ISDA strongly believes that there is an opportunity to simplify some of the current accounting literature relating to classification and measurement of financial instruments. By their nature, financial instruments are often complex. As such, there will always be a degree of complexity inherent in financial instrument accounting standards. However, in our view, many of the current issues arise as a result of the unnecessarily complex accounting rules within extant standards on financial instruments contained within both US GAAP and IFRS.

It has long been our position that high quality accounting standards should be developed on the basis of sound accounting principles and by simplifying the existing mixed measurement model, the Board would achieve its interim objective of reducing complexity in financial reporting.

However, when amending the existing provisions for financial instrument reporting, it will be important not to over simplify key principles to the point of reducing the quality and usefulness of financial reporting. In our detailed response below, we have identified the steps the Board may look to take to simplify existing standards.

### **Question 2**

*Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the question set out in Section 3.*

*Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?*

ISDA would support amending current accounting standards, in particular certain provisions contained in IAS 39, to address complexity arising from hedge accounting and the measurement of financial instruments. However, it is important that any changes to financial reporting provide more relevant and easily understandable information for users of financial statements and that a thorough analysis is performed to assess whether the benefits of a change in accounting guidance justify the additional costs.

ISDA supports the use of fair value for financial instruments held for trading or managed on a fair value basis as these instruments are generally traded by entities to benefit from short term price fluctuations and therefore measuring these financial instruments at fair value provides the most relevant information for users of financial statements.

However, where an entity is holding the instrument to benefit from its long term cash flows, most ISDA members believe a cost based measure is more appropriate as this largely reflects the actual cash amounts that the entity is likely to receive. Specifically, there are examples where an entity uses a cash flow model as this reflects the nature of the firm's business (for example, taking deposits and extending loans with no intention to sell or dispose of those loans until maturity). Consequently, fair value alone cannot provide the appropriate information for all types of financial assets. It is for this reason that we do not consider that changes should necessarily be consistent with paragraph 2.2(b). However, ISDA fully supports the criteria outlined in paragraphs 2.2(a), (c) and (d).

### **Question 3**

***Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?***

We believe the existing measurement requirements could be simplified by reducing the number of measurement categories of financial instruments. In particular, we would fully support a proposal to merge the held-to-maturity and loans and receivables categories of financial asset.

We would also encourage the IASB to explore the possibility of replacing the existing measurement requirements with two new categories of financial instruments. Under this proposal, financial instruments would be classified and measured at either fair value through profit or loss or at amortised cost. Many financial organisations hold certain portfolios of financial instruments as available-for-sale as they are not managed on a fair value basis and they are currently unable to record them as loans and receivables or held to maturity. These financial instruments are often held to mitigate risks within their banking portfolios on financial instruments that are not recorded at fair value. As a result we would only support such a proposal if the revised categories were defined in a way that allowed an entity to designate the financial instrument at inception as either fair value or amortised cost.

### **Question 4**

***Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.***

- a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph 2.2?***
- b) How should instruments that are not measured at fair value be measured?***
- c) When should impairment losses be recognised and how should the amount of impairment losses be measured?***
- d) Where should unrecognised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?***
- e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?***

As highlighted above and in our key messages, many of our members are unconvinced by the longer term objective of measuring all financial instruments at fair value. As such, the majority of our members are concerned that this approach would replace the existing measurement requirements with a fair value measurement principle with certain exceptions.

Furthermore, our members believe the proposal may result in the situation where the majority of financial instruments are accounted for on the same basis as they are today and therefore a significant amount of cost and effort could be expended for potentially little practical benefit. In addition, it is quite conceivable that by introducing a new list of exemptions, the Board may inadvertently increase the complexity of financial instrument reporting. We would therefore encourage the Board to focus their efforts on the proposals outlined in Approach 1 to simplify the existing measurement requirements.

### **Question 5**

*Approach 3 sets out possible simplifications to hedge accounting.*

- a) Should hedge accounting be eliminated? Why or why not?*
- b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.*
- c) Which method(s) should the IASB consider, and why?*
- d) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure your comments are consistent with your suggested approach to changing measurement requirements.*

Hedge accounting provides a valuable tool for financial statement preparers to communicate to financial statement users how a business manages the various financial risks it is exposed to. Therefore, whilst our members believe that there are significant opportunities to simplify hedge accounting, the ability to hedge cash flow, fair value and net investments should be retained.

We do not support the proposal outlined in paragraphs 2.37 to 2.43 of the discussion document, to restrict the availability of fair value hedge accounting to only those assets and liabilities that are not permitted to be measured using the fair value option. Such a restriction would in substance force members to measure the underlying hedged item at fair value as the vast majority of instruments for which our members apply fair value hedge accounting would qualify for the fair value option. ISDA is not convinced that such a fundamental restriction to the use of fair value hedge accounting is in any way outweighed by a perceived reduction in complexity. Members must be permitted to measure the underlying hedged item on a basis which reflects the way the entity manages the hedged item within the business.

The majority of our members would encourage the IASB to explore further the ‘recognition outside earnings of gains and losses on financial instruments designated as hedging instruments’ proposal as outlined in paragraphs 2.44 to 2.48 of the discussion document. This modified version of fair value hedge accounting, similar to cash flow hedging, would allow the effective portion of a fair value hedge relationship to be recorded in equity. We agree that using this

approach would significantly assist the users of financial statements because the hedged item would no longer be measured in the balance sheet as a hybrid of fair value and amortised cost.

We do not support the option to ‘recognise outside of earnings gains and losses on hedged items’ as described in paragraphs 2.49 to 2.54 of the IASB discussion document. This is because the proposal put forward by the IASB would require all (or at least many) financial instruments to be measured at fair value. Consistent with our earlier comments, we do not believe financial statement preparers should be forced to adopt a fair value measure in order to obtain the benefits of fair value hedge accounting. In our view, the perceived reductions in complexity from this proposal do not warrant removing the flexibility to measure financial instruments using methods other than fair value.

### **Question 6**

*Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting model affects earnings. This section also explains why those restrictions are required.*

- a) What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?*
- b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?*
- c) Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also explain why you believe the benefits of allowing partial hedges justify the complexity.*
- d) What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a hedging relationship can qualify for hedge accounting and how the application of hedge accounting models affects earnings?*

We acknowledge that hedge accounting is considered complex by many users and preparers of financial statements. Whilst it is important that hedge accounting should be retained, we believe that there are opportunities to simplify certain aspects of the current hedge accounting requirements.

In May 2007, the FASB took onto its agenda a project to simplify accounting for hedging activities with the objective to resolve practical issues that had arisen out of SFAS 133 and simplify accounting for hedging activities. Whilst as an organisation ISDA did not support many of the proposals outlined in the paper issued by the FASB in relation to this project, we did support the concept of replacing the notion of a highly effective hedging relationship and allow hedge accounting for ‘reasonably effective’ relationships. In addition, we also supported the proposal to allow a qualitative prospective assessment of hedge effectiveness in most circumstances at inception and prospectively with ineffectiveness measured on a quantitative basis with all ineffectiveness going to profit or loss. Whilst supporting these proposals, we did ask the FASB to provide further guidance to assist organisations in determining whether a hedge

is reasonably effective as well as when a quantitative evaluation is necessary versus a qualitative evaluation. We attach for your information a copy of our letter to the FASB as Appendix No. 2

If the proposals in our comment letter were accepted, hedge documentation would be simplified particularly when discussing the hedge strategy. This would significantly reduce the operational burden on companies that make use of hedge accounting.

ISDA does not support any restrictions on the application of partial hedges. Hedging instruments are often derivatives and are generally designed to manage discrete risks and therefore restricting partial hedges may result in disqualifying some of the most simple, effective hedging strategies that are currently used in practice. Whilst we agree that the hedging of individual risks associated with a financial instrument can be complex, in our view it is important to continue to allow this approach as this will result in more relevant financial information for the user.

In addition, ISDA does not support the proposal to restrict an entity's ability to de-designate and re-designate hedging relationships. The ability to start or discontinue with hedge accounting at any point in time is an important principle within the requirements of hedge accounting and removing this ability would have a significant effect on current practice and unnecessarily complicate hedge accounting practice. It is also worth noting that preparers could achieve the same outcome, albeit with additional transaction costs, by closing out an existing designated hedge relationship and entering into a new hedge transaction.

#### **Question 7**

***Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?***

In addition to the comments provided above, ISDA believe there are a number of other areas the IASB and FASB could consider to reduce complexity in reporting financial instruments.

The fair value through profit or loss category of financial instruments is unnecessarily complex because this category can only be used when the conditions outlined in IAS 39.9 are satisfied. ISDA members view these conditions as unnecessary. The United States has successfully adopted the FVTPL classification of financial instruments without the need for these complex criteria. ISDA encourages the IASB to amend IAS 39 by removing the preconditions for classification of financial instruments as FVTPL to both reduce complexity and for the sake of harmonisation with the US.

As part of this project, ISDA would encourage the IASB and the FASB to explore ways to simplify and harmonise the impairment provisions for financial assets contained in existing standards. Current impairment models are inconsistent and therefore can be confusing both when undertaking an assessment of whether there is objective evidence of impairment and determining when impairment losses should be reversed.

The equity method of accounting for investments where the reporting entity has significant influence adds to the complexity and variety of measurement methods for financial assets.



Complexity arises from determining whether an investor has significant influence over an investee and from accessing the necessary information to be able to apply the equity method of accounting. We would therefore encourage the IASB to consider the options to account for these investments, including providing the ability to fair value these instruments, consistent with guidance existing under US GAAP.

#### **Question 8**

*To reduce today's measurement-related problems; Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments.*

*Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?*

Whilst we are strong supporters of using fair value to measure many financial instruments, in certain situations the majority of our members consider measuring financial assets and financial liabilities using an attribute other than fair value as a more appropriate measurement basis.

The IASB's *Framework for the Preparation and Presentation of Financial Statements* states that the objective of financial reporting is "to provide information about the financial position, performance and changes in the financial position of an enterprise that is useful to a wide range of users in making economic decisions". Certain ISDA members consider that a single method of measurement could reduce complexity by eliminating the current rules used to classify financial instruments that result from a mixed measurement model. In addition, a single measurement system could enhance financial statement comparability across entities; adding further strength to a key argument often sighted for adoption of IFRS i.e. global comparability of financial statements.

However, it is the view of the majority of our members that for financial statements to be decision useful, they should be prepared so that they provide information that is relevant given the way that businesses are managed and operated so that they can be used as a reasonable basis for ex-ante judgements on performance. Financial instruments are held by entities for different purposes and the measurement of both financial assets and financial liabilities should reflect the underlying economics of why they are held. In their opinion, where an entity does not intend on trading positions, using current market values to predict future cash flows could be misleading, as it represents cash flows that the reporting entity is unlikely to ever realise. In these situations, whilst the fair value may reflect the price at which an instrument could be disposed of at the reporting date, a cost based measure may be more appropriate as this largely reflects the actual cash amounts that the entity is likely to receive.

In our view, much of the complexity in financial instrument reporting is not created by the mixed measurement model of IAS 39 but by the complexity of the rules embedded in the standard. Take for example the detailed rules on impairment of financial assets. There are practical

differences in IAS 39 between the measurement of impairment for an asset held as available-for-sale and financial assets held at amortised cost. By reviewing and aligning the principles and guidance contained in IAS 39 the Board would simplify the accounting and make the financial reporting between institutions more transparent, easier to understand and more comparable.

We also emphasise that whilst IAS 39 allows different approaches to the measurement of financial instruments, similar options are available in many other International Financial Reporting Standards and therefore IAS 39 is not necessarily more complex than other Standards. Take for example IAS 40 on Investment Properties. IAS 40 allows an organisation a choice between accounting for investment properties at cost or at fair value. There are many similar “options” in other International Financial Reporting Standards and the majority of our members continue to believe that the ability to account for assets and liabilities in accordance with the way the business is actually managed results in better quality financial reporting.

There are differing views within our industry and the broader financial reporting community on the most appropriate long term solution to reporting financial instruments. As a result, it is likely to take a significant amount of time before an acceptable proposal is arrived at. We would therefore encourage the IASB to focus their efforts on the medium term objective of amending aspects of IAS 39 with the aim of striking a better balance between rules and principles to reduce complexity in financial reporting.

#### **Question 9**

*Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.*

- a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?*
- b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today’s measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?*

Please see our response to Question 8.

#### **Question 10**

*Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?*

We do not believe there are any other significant outstanding concerns among our members in applying fair value measurement to financial instruments.

**Question 11**

*Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments.*

*(a) Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?*

*(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?*

We encourage the IASB to focus on its medium term objective of amending IAS 39 to reduce complexity. We do not believe it will be possible at this stage to pursue the Boards' longer term objective of the full fair value model set out in the Discussion Paper.

Notwithstanding the above, if the Board were to adopt such an approach then we agree that matters reflecting scope, presentation, disclosure and measurement will need to be addressed.

In particular, we have previously written to the IASB to express our view that given the global nature of financial markets, it is critical that there is a single definition and framework for the determination of fair value. In the absence of this, we remain deeply concerned with the possibility that the same financial instruments traded in the same principal market could have a different reported fair value under IFRS and US GAAP. In our view, it therefore remains of paramount importance that the IASB complete their work on Fair Value Measurement before there are further discussions on reducing the complexity in financial reporting for financial instruments.

**Question 12**

*Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?*

We do not have any other comments on the proposals.

**Appendix No. 2 – ISDA response to the FASB on “Accounting for hedging activities, an amendment to FAS 133”**

August 15, 2008

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 1590-100, Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133***

Dear Mr. Golden:

The International Swaps and Derivatives Association (ISDA) appreciates the opportunity to provide comments and observations on the Financial Accounting Standards Board’s (“FASB”) Exposure Draft of Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133* (the “Exposure Draft”). ISDA members represent leading participants in the privately negotiated derivatives industry and include most of the world’s major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.

ISDA is supportive of the FASB’s efforts to simplify the accounting for hedging activities and also resolve the practice issues that have arisen under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities, As Amended* (“SFAS 133”), as well as to address user’s concerns regarding the accounting for and reporting of hedging activities. However, we do not believe the Exposure Draft as currently drafted meets the FASB’s objectives of simplification and increased transparency because the changes will significantly increase the complexity of hedge accounting for many of the most simple and common hedge relationships such as swapping fixed rate financial instruments to floating. The Exposure Draft will also create as many new practice issues and user concerns as it resolves. In addition, the effect of certain of the amendments to SFAS 133 will be so severe that many companies hedging discrete risks will likely not qualify for hedge accounting, or may qualify but choose not to utilize hedge accounting in order to avoid income statement results unrepresentative of their hedging activities and financial position.

At the heart of these added complexities is the FASB's decision to eliminate the bifurcation-by-risk approach. We believe that firms will struggle with the requirement to include own credit risk in hedges of forecasted issuances of debt and rollovers of short term floating rate debt, just as firms have struggled with the inclusion of credit risk in the valuation of derivatives under SFAS 157. Further, for certain companies, the inclusion of risks that are not hedged (some of which are not possible to hedge) in a hedge accounting relationship will cause some of the most simple and common hedging strategies using interest rate swaps to be disqualified even under a "reasonably effective" standard. For those that will continue to qualify, the inclusion of unhedged and unhedgeable risks will increase the asymmetry between the accounting results and risk management results that SFAS 133 originally sought to reconcile. This result surely does not achieve the FASB's stated objectives.

ISDA believes that the Exposure Draft also fails to achieve its simplification objective due to the removal of the two fundamental aspects of SFAS 133 that currently simplify hedge accounting in practice without providing an equivalent simplification as a replacement. In ISDA's view, the shortcut method described in paragraph 68 of SFAS 133, and the matched terms approach described in paragraph 65 of SFAS 133 and DIG Issue No. G9 greatly simplified the accounting for many hedges in practice that would otherwise be much more difficult under both SFAS 133 currently, and under the Exposure Draft. In the absence of an approach that alleviates the operational burden of both assessment and measurement for these simple hedges, amending the current hedge accounting model as proposed is not justified in a simplification project. ISDA strongly recommends the FASB to reconsider its decisions regarding the elimination of the shortcut method and matched terms approaches and to approach a simplified hedge accounting framework based on enhancing the simplifications that already exist in SFAS 133.

Although we are aware of the FASB's desire to further its aim of accounting for all financial instruments at fair value, we question the appropriateness of using an amendment to a hedge accounting model as a means to further that goal. We believe that the relative merits of the different measurement attributes for financial instruments used in different activities should be deliberated directly in its own project, and not indirectly and on a piecemeal basis in this project. We further believe that any concerns about increased information about unhedged risks would be far better addressed through a project to create a comprehensive disclosure framework for financial instruments, and not just those that a preparer elects to hedge under SFAS 133. Unlike the Exposure Draft, this approach would place hedgers and non-hedgers on a level playing field with respect to measurement and disclosure of hedged and unhedged risks.

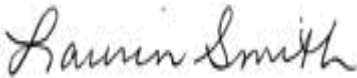
We also question the urgency of issuing guidance to amend SFAS 133 so drastically after eight years in practice, during which time consensus has been achieved on the large majority of issues of interpretation and implementation. ISDA believes that the existing practice issues could be addressed with limited and specific changes to SFAS 133, and that the FASB should only undertake projects intended to either address convergence or urgently needed and justifiable changes to financial reporting. Additionally, in light of the FASB's recently renewed Memorandum of Understanding with the International Accounting Standards Board (IASB) to converge the U.S. GAAP and IFRS, and the public support by certain U.S. organizations for a move toward a single set of global accounting standards in the near term, we must question the merits of amending SFAS 133 in a manner that diverges from the existing IFRS hedge

accounting model. We therefore strongly recommend that the FASB halt its project to amend SFAS 133 and jointly develop a plan with the IASB to converge to a global hedge accounting model incorporating the comments received on this Exposure Draft and the IASB's Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*.

Finally, although we understand that the proposed amendment to paragraph 40 of SFAS 133 is intended to be a clarification of the FASB's original objective for intercompany foreign currency cash flow hedges, ISDA believes that this amendment represents a fundamental change to the hedge accounting model, and the FASB's original decisions as outlined in paragraphs 482 through 484 of SFAS 133's Basis for conclusions. Accordingly, ISDA believes that such a fundamental change deserves the full deliberation by the Board and opportunity for constituents to understand the Board's basis for disagreement with paragraphs 482 through 484 of the SFAS 133 Basis for conclusions. If there is any doubt regarding the original intentions regarding hedgeable intercompany risks and how this is being applied in practice, we believe that this matter should be addressed as part of a separate project that evaluates the cash flow hedge accounting model together with SFAS 52.

Our responses to the questions included in Exposure Draft's Notice for Recipients as well as other comments on the Exposure Draft are included in Appendix A attached. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned at 212-648-0909 or Hee Lee, Partner, Ernst & Young, ISDA's external accounting advisor, at 212-773-8605.

Sincerely,



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

## **Appendix A: ISDA’s Responses to Questions in Notice for Recipients and Other Comments on Exposure Draft’s Provisions**

### **Hedged Risk**

*Issue 1/Question 1: Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?*

In ISDA’s view, eliminating bifurcation-by-risk from SFAS 133 significantly increases the interpretive and operational burdens of hedge accounting, and has the potential to diminish the application of hedge accounting to many common interest rate risk management transactions. Further, the inclusion of risks not hedged in the hedged item or transaction that are not or cannot be economically hedged will increase the asymmetry between the accounting results and risk management results that SFAS 133 originally sought to reduce. We do not agree with the Board’s basis (discussed in paragraph A19 of the Exposure Draft) for not permitting companies to hedge a benchmark interest rate prior or subsequent to the inception of a company’s own debt. We do not understand why locking in an interest rate prior to acquisition of an asset or issuance of debt or subsequently transforming the interest rate risk of a recognized asset or liability is not appropriate for benchmark interest rate risk designation. Our comments immediately below as well as the supporting examples included in Appendix B attached highlight the consequences of the elimination of bifurcation by risk for common interest rate hedges and risk management strategies.

#### *Benchmark Interest Rate Designation – Forecasted Issuances of Debt*

For forecasted debt issuances, some components of the coupon that an entity would be charged by creditors are simply not hedgeable, such as supply/demand basis risk and credit risk above the Treasury or swap rate. Basis risk is based on the supply and demand in the market for that debt as of the particular date a hedger begins to access the debt capital markets. Because basis risk is not price based or index based but is solely a function of investor behavior on a particular day and time in response to that day’s market events, it is unlikely to ever be hedgeable in observable derivative markets. Similarly, market participants rarely enter into derivative transactions in which the counterparty seeks to hedge its own credit risk due to the “wrong way” risk and concerns on both sides about insider information (self dealing), enforceability in bankruptcy and reputation risk. Furthermore, many issuers do not have an observable credit spread for the full term structure of the debt they anticipate issuing. We must highlight therefore the difference, especially with respect to own credit and basis risk, between choosing not to manage a risk, and being unable to manage certain risks at any cost or any reasonable cost.

The implementation of SFAS 157, *Fair Value Measurements*’ requirement to mark derivative liabilities for an entity’s own credit risk and the credit market crisis have demonstrated some of the practical difficulties resulting from accounting measurements based on theoretical transactions, and the public concerns that these measurements raise. The current benchmark interest rate risk designations are based on the simplest, most liquid derivative instruments.

Derivatives that hedge overall changes in cash flows of forecasted own debt issuances are essentially not available due to the inability to hedge basis risk and own credit discussed above, and therefore the fair value measurements of hypothetical derivatives used to calculate hedge effectiveness pursuant to the Exposure Draft would be based on purely theoretical instruments in theoretical markets. ISDA believes that the current hedge accounting framework's foundation on actual risk management instruments with observable market inputs for hedges of interest rate risk is preferable to that proposed in the Exposure Draft, which results in accounting measurements based on theoretical risk management instruments valued using lower level inputs. This lack of observable inputs exacerbates the "quality of earnings issue" because ineffectiveness caused by the derivative that would exactly offset the hedged item will be reported in earnings due to the proposed change to paragraphs 30(b) and 30(c) of SFAS 133.

This proposed amendment's application to forecasted debt issuances raises fairness and comparability issues as well. For example, some companies, such as those who (i) issue frequently so that their basis risk is reasonably predictable and (ii) have small and stable credit spreads, may be able to determine that a forward starting swap or Treasury rate lock hedging instruments are reasonably effective in hedging total changes in cash flows after a qualitative assessment, or if needed, a quantitative assessment. These companies would qualify for hedge accounting, and the consequent construction of a perfect derivative hedging both their basis risk and credit spread would be marked to market through other comprehensive income (OCI). These companies would then recognize interest expense over the life of the issued debt reflecting amounts that will suggest their credit and basis risk had been hedged, in addition to the benchmark interest rate risk actually hedged. In contrast, other companies, such as those who issue debt infrequently, so that basis risk is not qualitatively (or quantitatively) assessable or those companies with large or volatile credit spreads, would likely not qualify for hedge accounting even though they could highly effectively hedge the benchmark interest rate risk component of the future issuance. In Appendix B attached, we quantitatively illustrated the implications of FASB's proposed elimination of bifurcation-by-risk for two common fair value hedge accounting relationships involving interest rate risk.

In summary, ISDA is troubled by the proposed accounting model for forecasted debt issuances for four reasons. First, many simple and prudent hedges would cease to qualify for hedge accounting. Second, the financial statements of companies that hedge at inception versus those that hedge a forecasted debt issuance would potentially have different accounting measurements of interest expense despite parallel economic hedging objectives because one hedge accounting relationship does not include changes in credit while the later does. Third, a company that hedges the benchmark interest rate in a forecasted debt issuance will be forced to reflect in earnings changes in credit and new issue premium prior to issuance and then report interest expense as if both interest and credit/premium had been in fact hedged economically, while a company that does not hedge the benchmark interest rate of a future debt issuance will have no earnings effect prior to issuance and will report interest expense that reflects an unhedged credit spread equal to their actual new issue premium. We believe that the only difference in reporting between these two companies should be the effect of the interest rate hedge, and not different treatments of unhedged items. Finally, the proposed model will reduce comparability among companies, creating a divide between stable, high-credit quality frequent issuers who can qualify for hedge accounting versus infrequent issuers, volatile low-credit quality issuers, and all other



issuers in between. ISDA does not understand how this model improves the comparability and representational faithfulness of financial reporting or simplifies preparer or analyst process burden.

*Benchmark Interest Rate Designation – “At Inception” Requirement*

As proposed, the narrow exception for hedging changes in a benchmark interest rate of one’s own debt hedged at inception date will preclude benchmark interest rate risk designation for many common hedges and will significantly affect companies’ risk management strategies. Many of the cash flow hedges of forecasted interest payments on a company’s own debt relate not only to floating rate debt instruments but also to rollovers of short term debt explicitly based on LIBOR. The “at inception” rule therefore creates an accounting bias for long term (both floating and fixed rate) versus short term (rollover) funding. Because certain short term funding instruments such as deposits have proven to be a stable and important source of liquidity, we question why an accounting framework should create such a bias. In addition to disadvantaging the hedging of rollovers of short term obligations, the proposed amendment causes issues for long term borrowings as well. For example, because almost all variable rate credit facilities and other term financing vehicles permit the borrower to prepay at par on any reset date, companies asserting the probability of cash flows for the full term of callable floating rate debt are required to consider not only the existing debt, but any subsequent refinancing after each call date. Thus, typical floating rate credit facilities may not qualify for benchmark interest rate risk designation under the Exposure Draft even if designated at the inception of the debt, because future cash flows during the term of the debt but after a call date may relate to forecasted issuances of debt.

Moreover, there are many circumstances that can result in the amendment or replacement of a derivative hedging instrument, such as a “recoupon”<sup>1</sup> or novation<sup>2</sup>. The inability to designate a benchmark interest rate risk hedge after inception even though a derivative was replaced and the entire hedge relationship from inception was effectively still in place (albeit with a modified swap) would increase the complexity of applying hedge accounting, requiring users to understand the results of a switch from a benchmark interest rate risk hedge to an overall hedge. The Exposure Draft may be interpreted to require preparers to redesignate existing hedges as overall risk hedges in response to these types of amendments/replacements, or to cause preparers to abandon interest rate risk management strategies entirely in order to avoid the resulting accounting volatility. At a minimum, we believe that hedge accounting should be allowed to be continued if an existing qualifying derivative is modified or replaced if an amendment to SFAS 133 is adopted by the FASB.

*Benchmark Interest Rate Designation – Hedges of Forecasted and Existing Investments in Financial Assets*

The issues discussed above regarding the limitations on hedging a benchmark interest rate impact not only a company’s own debt, but also interest bearing financial instruments in which a

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<sup>1</sup> In a “recoupon”, an interest rate swap unrealized gain or loss is cash settled between the counterparties to reduce the credit risk, and a new swap at on-market terms is transacted to the same maturity as the original swap.

<sup>2</sup> Legal novation of derivative contracts to new counterparties are common risk mitigation mechanisms to limit counterparty credit risk exposure and have increased as a result of the recent dislocation in the credit markets.

company invests or for which it is otherwise the creditor. Financial institutions commonly designate a benchmark interest rate hedge of forecasted interest payments to be received on a portfolio of variable rate consumer loans, the composition of which continually changes. The Exposure Draft's elimination of bifurcation-by-risk designation for assets would require hedging entities to undertake the complex task of determining the appropriate credit spread and basis risk associated with the existing and forecasted loans within the portfolio. Since the loan portfolios of many financial institutions and finance companies are comprised of obligors (such as consumers) that do not have publically traded debt or an observable credit spread, ISDA is greatly concerned that hedges of a company's assets for overall changes in fair value or cash flow will give rise to (1) the same inability to achieve hedge accounting and (2) the same impact on prudent interest rate risk management, both of which we discussed above with respect to forecasted and "late" debt hedges. Since the FASB has not justified its basis for distinguishing between which financial instruments can continue to qualify under the bifurcation-by-risk approach, we strongly disagree with this proposed amendment to SFAS 133.

*Benchmark Interest Rate Designation – Fixed-Rate Callable Debt*

Under current practice, use of the shortcut method for fair value hedges of fixed-rate callable debt is widespread, especially for the firms using the most basic forms of derivatives and hedge accounting. We find that the Exposure Draft is not operational due to the elimination of the simplified treatment of callable debt under the shortcut method, especially for these preparers. Under the long-haul method, some advisors currently permit the mark on the call option to be limited to changes in the benchmark interest rate, consistent with how the remaining cash flows on the debt are marked under the long haul method, while other advisors insist that paragraph 92 forces the embedded call option be "fully marked" (i.e., including credit risk). Under the latter view, some of the most sophisticated users of hedge accounting and derivatives have found hedge accounting for fixed-rate callable debt to be highly complex, and do not hedge callable debt entirely due to this complexity.

Further, aside from the interpretive and operational issues regarding hedges of fixed-rate callable debt, a significant source of the complexity for these hedges is that derivatives that would be reasonably effective in offsetting overall changes in an issuer's own callable debt are not currently available, as many derivative counterparties are unwilling or unable to assume the incremental risks or capital requirements associated with own-credit risk instruments. Given the pervasive nature of this risk management strategy for shortcut method fair value hedges, we strongly advise the FASB to reconsider the cost-benefit of eliminating the shortcut method, as application of long haul method to fixed-rate callable debt would introduce significant complexity to hedge relationships that are otherwise simple. Should the FASB decide to move forward with issuing a final statement that is consistent with the Exposure Draft, we strongly recommend a full vetting of this issue during its redeliberation process.

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

As discussed in our response to Issue 1/Question 1 above, we do not agree with the FASB's proposal to eliminate the bifurcation-by-risk approach currently provided in SFAS 133 because

doing so significantly increases the interpretive and operational and administrative burdens of hedge accounting, and has the potential to diminish the application of hedge accounting to many common interest rate risk management transactions. We do not agree with the Board's basis for not permitting companies to hedge a benchmark interest rate prior or subsequent to the inception of a company's own debt and strongly disagree that companies should not be permitted to hedge the benchmark interest rate inherent in financial assets.

The retention of the bifurcation-by-risk approach for financial instruments is necessary and valid for several reasons. As discussed more fully above, not all components of a company's own credit spread can be hedged due to market factors and other issues, and, therefore, the requirement to include risks that are not and which cannot be hedged into the financial statements reduces the usefulness and faithful representation of a hedger's financial position and reported results. Companies select the derivative that best and most simply reflects the risk being hedged economically, and the proposed rescission of the bifurcation-by-risk approach would force companies to replace derivatives based on observable and liquid indices with derivatives that incorporate new (and often unobservable) risks they never intended to hedge (assuming they are even available). If companies are unable to alter their hedging instruments to incorporate all risks inherent in the hedged item, they will have three mutually exclusive choices: (1) choose not to apply hedge accounting and increase earnings volatility from the hedged risk, (2) apply hedge accounting, if possible, but face increased earnings volatility from the unhedged risk, or (3) not hedge and incur no volatility but retain economic risk. In practice, preparers have found the explanation of earnings volatility from items not meeting the current SFAS 133 hedge accounting criteria to be difficult to explain to users. In summary, we fail to understand how the additional burdens imposed by this Exposure Draft simplify hedge accounting and improve financial reporting.

Finally, although we are aware of the FASB's desire to further its aim of accounting for all financial instruments at fair value, we question the appropriateness of using an amendment to a hedge accounting model as a means to further that goal. We believe that the relative merits of the different measurement attributes for financial instruments used in different activities should be deliberated directly in its own project, and not indirectly and on a piecemeal basis in this project. We further believe that any concerns about increased information about unhedged risks would be far better addressed through a project to create a cohesive disclosure framework for all financial instruments, and not just those that a preparer elects to hedge under SFAS 133. Unlike the Exposure Draft, this approach would place hedgers and non-hedgers on a level playing field with respect to measurement and disclosure of hedged and unhedged risks.

Therefore, ISDA believes that the bifurcation-by-risk framework should be retained for all hedged items currently eligible to be designated in benchmark interest rate hedges under SFAS 133.

### **Hedge Effectiveness**

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

*Measurement of Hedge Effectiveness – Cash Flow Hedges*

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

Requiring the use of a derivative that exactly offsets the hedged cash flows while simultaneously removing guidance that assists in 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 SFAS 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.

Additionally, paragraph 23 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 23 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.

Accordingly we recommend that the FASB make the following changes to paragraph 23 of the Exposure Draft (inserted text is underlined).

**23. 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, depending on the nature and terms of the hedged transaction, either reset on the same date as the hedged item or mature on the date of the forecasted transaction, be priced at market, have the same critical terms\* as the hedged transaction, and provide cash flows that would exactly offset the variability of the hedged cash flows.**

\* The critical terms are those that affect the variability of the hedged cash flows attributable to the hedged risk by more than a de minimis amount.

ISDA recommends that the FASB retain guidance 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 SFAS 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.

***Issue 3/Question 3b: Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?***

In ISDA's judgment, the shortcut method is the most representationally faithful reflection of the common 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 certain of the various measurement and basis adjustment amortization methods required by certain independent public accounting firms, similar representational faithfulness in income statement results cannot be achieved under the long haul method, even if the long haul hedge relationship were to be assessed to have exactly zero ineffectiveness. Further, as entities that issue long-dated debt instruments that have significant credit spreads may not qualify for hedge accounting under the "long haul" method (refer to our response to Question 1 above regarding forecasted debt hedges), this proposed amendment may preclude the use of hedge accounting for those entities entirely. 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 SFAS 133. 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.

Likewise, the critical terms matching guidance of DIG Issue No. G9 for cash flow hedges has been a useful framework for companies that design their hedges to match the terms of the hedged transaction and permits a simple and practical application of SFAS 133's effectiveness assessment and measurement criteria. This guidance allows companies to properly apply hedge accounting without the addition of significant cost, resources, and complex valuation and risk systems. In applying a critical terms matching approach to cash flow hedges, companies also often utilize the shortcut criteria (other than paragraph 68(d) of SFAS 133) as a guide to assess and measure hedge effectiveness. As discussed in question 3a above, we strongly recommend the FASB retain the guidance on paragraph 65 and DIG Issue No. G9 for the purposes of assessing hedge effectiveness and measuring ineffectiveness.

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

ISDA members support the concept of lowering the hedge assessment qualification threshold from highly effective to reasonably effective and believe this proposed change will simplify hedge accounting for certain hedge relationships. However, when considering the elimination of the bifurcation-by-risk approach, we believe that it will not be possible to conclude that many hedge relationships will be reasonably effective based solely on a qualitative assessment due to the requirement to consider variability in all risks, not just the risk being economically hedged. Thus many hedge relationships will require a quantitative assessment of hedge effectiveness in order to qualify for hedge accounting, which drastically reduces the simplification realized under the proposed change. In Appendix B attached hereto, ISDA has illustrated that the effectiveness of an interest rate swap in an overall fair value hedge will have sufficient variability to require quantitative assessment even for highly rated companies, and will likely fail to meet a reasonably effective threshold for hedges of lower rated (but still investment grade) debt due to companies being forced to include in accounting measurements unhedged risks which have little statistical relationship to interest rate movements. We note that the likely interpretation of the phrase in paragraph A7 "in situations in which it is *obvious* that a hedging relationship is effective" may preclude qualitative assessment for almost all types of hedge relationships. (*emphasis added*)

ISDA recommends that the FASB provide criteria in the final standard that will assist companies in determining whether a hedge is reasonably effective as well as when a quantitative evaluation is necessary versus only a qualitative evaluation. These criteria might include some of the criteria set forth in paragraph 65 of SFAS 133 or DIG Issue No. G9, which companies are currently using in practice. ISDA feels that some specific guidelines are necessary as auditors and regulators are likely to develop their own perceptions of and quantitative thresholds for what meets their definition of "reasonably effective" which will only lead to more diversity and complexity in applying the new rules.

Furthermore, we think the proposed standard should include more examples illustrating when a qualitative assessment is sufficient and when it is not for some of the most common hedging

strategies. These examples should include interest rate and equity derivatives. The interest rate examples should include (1) a hedge of forecasted debt issuance using a forward starting swap or Treasury rate lock, (2) an interest rate swap converting callable, fixed rate debt to floating, (3) an interest rate swap converting floating rate debt to fixed, and (4) interest rate caps to hedge floating rate debt. The equity examples should include (1) a purchased option to hedge an SAR liability, (2) an equity collar to hedge the forecasted sale of an available-for-sale (AFS) marketable equity security and (3) a forward to hedge the forecasted purchase of an AFS marketable equity security. There should also be two examples for each of these derivatives, one in which a qualitative assessment is sufficient, and one in which it is not. Preparers and auditors will then have a clear, conceptual road map for the financial derivatives that they and their clients are most likely to enter into and designate as hedges under SFAS 133. ISDA further recommends the FASB to facilitate field testing of these examples by a selected number of financial statement preparers prior to issuing any guidance that amends the current SFAS 133 hedge accounting model.

Lastly, although paragraph 6 of the External Reviewer Draft relaxes the conditions that must be met for a relationship between a hedging instrument and a hedged item to qualify for special hedge accounting, paragraph 21(a)(1) of SFAS 133 regarding the conditions for whether a portfolio of similar financial instruments can be designated in a fair value hedge has not been amended to reflect the less restrictive threshold for applying special hedge accounting. We are unclear as to whether the FASB intended to keep the thresholds similar. We do not believe that any portfolio hedges of overall changes in fair value or cash flow would qualify under the existing threshold, as any one financial instrument within the portfolio would not be expected to react to changes in borrower-specific credit spreads in a highly similar (80-125%) fashion. ISDA believes that the accounting result described in paragraph A17 of the Exposure Draft which states, “If the designated hedged risk in a cash flow hedge is the risk of overall changes in interest payments to be received related to a variable-rate financial asset, it would still be possible, in certain situations, to obtain financial statement results similar to those that could be obtained if interest rate risk were permitted to be the designated hedged risk...” would be applicable to a very limited number of situations in practice, and likely not at all for hedges of portfolios. Thus, not amending paragraph 21(a)(1) of SFAS 133 to be consistent with the reasonable effective criterion in the paragraph 6 of the Exposure Draft would preclude almost all hedges of financial instrument portfolios from qualifying as either fair value or cash flow hedges.

Accordingly, we strongly recommend that the FASB amend paragraph 21(a)(1) to reflect paragraph 6’s criteria and therefore permit a portfolio of similar financial instruments to be designated as long as they have reasonably similar risks that are expected to be reasonably offset by the hedging instrument.

***Issue 4/Question 4b: For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed Statement (except for an entity’s own issued debt at inception), do you believe you would continue to qualify for hedge accounting utilizing your current hedging strategy?***

As previously discussed in this letter, we believe that many common, simple and prudent risk management strategies will no longer qualify for hedge accounting due to the requirement to include credit risk in the assessment of reasonable effectiveness when the risk economically hedged is solely due to changes in benchmark interest rates. For example, companies who issue debt infrequently and those with large or volatile credit spreads would likely not qualify for hedge accounting. Similarly, hedges of portfolios of loans would likely not qualify for hedge accounting.

We believe that the pullback from hedging that was observed when SFAS 133 first was implemented until the rules were interpreted and understood and systems and processes were redesigned to accommodate the new rules will likely occur again upon transition. However, unlike the implementation of SFAS 133 and its related amendments, the Exposure Draft will not allow companies to move to simpler hedging instruments and hedge accounting strategies in order to achieve income statement results that reflect the economics of the risks being hedged, such as the shortcut method and critical terms matching approach, and thus we believe there will be pressure not to apply hedge accounting in all but the most compelling situations.

Please refer to ISDA's response to Issue 1/Question 1 above as well as the examples illustrating hedges of overall changes in fair value to two common interest rate hedge accounting relationships in Appendix B attached.

***Issue 4/Question 4c: If not, would you (a) modify your hedging strategy to incorporate other derivative instruments, (b) stop applying hedge accounting, (c) elect the fair value option for those financial instruments, or (d) adopt some other strategy for managing risk?***

The organizations that comprise ISDA's North America Accounting Committee and their clients would likely attempt to modify their hedging strategies in a manner that best reflects the economics of their economic hedging objectives but also which minimizes ineffectiveness and volatility in earnings. Depending upon the volatility of the credit spreads of the hedged item, many companies may cease applying SFAS 133 hedge accounting, while other companies may cease managing risk with derivative financial instruments entirely. The examples attached in Appendix B illustrate that companies with volatile credit spreads will likely not qualify for hedge accounting even though the threshold has been lowered to being reasonably effective. ISDA foresees few companies adopting the fair value option for items that are currently designated in SFAS 133 hedges because companies had an opportunity but chose not to elect the fair value option for these items upon the initial adoption of SFAS 159.

***Issue 5/Question 5a: Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period?***



Once sufficient clarity is provided for when a qualitative assessment is sufficient and a quantitative assessment is not required, ISDA does not foresee any significant operational concerns in creating processes to identify circumstances that suggest that a hedging relationship (for which a qualitative assessment is permitted at inception) is no longer reasonably effective. As noted above, however, ISDA believes that the elimination of the benchmark interest rate risk designation for many common hedging relationships will continue to require ongoing quantitative hedge effectiveness assessments due to the requirement to include variability due to credit risk in the assessment.

***Issue 5/Question 5b: Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? If so, why?***

As discussed in our response to Issue 4/Question 4a above, ISDA foresees the number of hedge relationships where solely a qualitative effectiveness evaluation is permitted to be limited. As such, companies will be required to perform a quantitative evaluation of hedge effectiveness at inception of a hedge. Because many hedge relationships will not qualify as benchmark interest rate hedges, the complexity associated with including credit spreads in the evaluation of hedge effectiveness will require both at inception and going forward a quantitative evaluation, and therefore will not diminish the need to perform a subsequent evaluation of hedge effectiveness.

ISDA believes that, even for the most basic of hedges involving financial instruments, if a company quantitatively evaluated hedge effectiveness at the inception of the hedge relationship, auditors will likely require companies to subsequently validate that the hedge is expected to be reasonably effective. For the reasons discussed in Issue 1/Question 1 (related to hedges of debt instruments), hedges that are initially deemed reasonably effective could easily be disqualified as eligible for hedge accounting due to the requirement to include credit risk in the assessment of hedge relationships economically designed to only address interest rate risk, and thus we do not believe that the proposed amendments to SFAS 133 will result in a reduction to the number of times hedging relationships using interest rate swaps would be discontinued.

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

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~~).

7. 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 and circumstances therefore suggest that the hedging relationship may no longer be reasonably effective.

***Issue 6/Question 6b: Alternatively, should an effectiveness evaluation not be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term?***

Since the Exposure Draft has retained the requirement to perform an effectiveness assessment at the inception of a hedge, and because a hedge must be expected to be reasonably effective over the life of a hedge relationship, we believe a subsequent evaluation of hedge effectiveness is necessary in certain circumstances. As discussed above, 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.

See ISDA's response to Issue 6/Question 6a above.

### **Financial Statement Presentation**

***Issue 7/Question 7: Do you believe that Statement 133 should be amended to prescribe the presentation of these amounts? For example, the Statement could require that the effective portion of derivatives hedging the interest rate risk in issued debt be classified within interest expense and that the ineffective portion and any amounts excluded from the evaluation of effectiveness be presented within other income or loss.***

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

### **Effective Date and Transition**

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

### *Effective Date*

In summary, ISDA strongly objects to the issuance the Exposure Draft because it would (1) increase rather than decrease the complexity associated with the accounting for and reporting of hedging activities, and (2) reduce the transparency of financial statements, and therefore does not meet the FASB's project objectives. Also, due to the significant increase in complexity introduced by the Exposure Draft, we fervently believe that the proposed effective date would not provide nearly enough time for most companies to adopt the proposed Statement. Additionally, in light of the FASB's recently renewed Memorandum of Understanding with the International Accounting Standards Board (IASB) to converge the U.S. GAAP and IFRS, and the public support by certain U.S. organizations for a move toward a single set of global accounting standards in the near term, we must question the merits of amending SFAS 133 in a manner that diverges from the existing IFRS hedge accounting model, especially when a piecemeal approach to convergence with IFRS would require preparers under U.S. GAAP to adopt new hedge accounting models twice in a relatively short time horizon. Further, as amendments to the existing hedge accounting framework under IAS 39 continue to evolve, there is a risk that any convergence with IFRS achieved through the FASB's project to simplify hedge accounting could be subsequently changed within a short time period. Accordingly, we strongly recommend that the FASB discontinue its project to simplify SFAS 133 and jointly develop a plan with the IASB, the goal of which could be the development of a single, principles-based hedge accounting framework.

### *Transition*

The transition provisions of the Exposure Draft would require all hedging relationships, except those in which the designated risk(s) are exactly the same before and after adoption to be dedesignated and designated anew using the qualifying criteria of Statement 133 as amended by this proposed Statement and certain benchmark interest rate hedges designated prior to transition, and which began after the inception of a company's own debt.

However, we believe that almost all hedge relationships will need to be redocumented if not dedesignated at the effective date due to the change in (i) the risks that can be hedged and (ii) the methods of assessing and measuring hedge effectiveness required before and after the effective date. For example, the assessment of effectiveness would change from a "highly effective" to "reasonably effective" threshold and quarterly assessments would no longer be required unless circumstances suggest that the hedging relationship may no longer be effective. Consequently, although the risk being hedged may be the same, the previous documentation regarding assessing and measuring ineffectiveness would be obsolete in accordance with the provisions of the Exposure Draft, thus requiring dedesignation and designation anew under revised hedge documentation. Therefore, the FASB needs to consider providing additional guidance on the transition provisions for hedging relationships for which the hedged risk remains the same.

Lastly, it is unclear from the Exposure Draft whether any adjustments to accumulated other comprehensive income associated with hedges that are terminated prior to transition are required. Because paragraph 34 of the Exposure Draft implies that retrospective application is only required for existing hedge relationships that either continue uninterrupted at transition or those

hedges that are designated anew at transition, we recommend that the FASB incorporate the following modifications to paragraph 33 into the final standard (inserted text is underlined).

33. This Statement does not require any adjustments to the statement of financial position on the date of initial application for fair value hedges. Additionally, this Statement need not be applied to cash flow hedging relationships that were terminated prior to the date of its initial application.

***Issue 9/Question 9: Do you believe that there are specific disclosures that should be required during transition? If so, what? Please be specific as to how any suggested disclosures would be used.***

Although ISDA does not believe that there is a need for specific disclosures that should be required during transition, we reiterate our strong disagreement with the issuance of a final statement that reflects the Exposure Draft's proposed changes to SFAS 133 because of the significant complexity it introduces into the hedge accounting model and the counterintuitive results, particularly for interest rate hedges. In lieu of amending SFAS 133 consistent with the provisions of the Exposure Draft, we instead would support a comprehensive project to enhance the disclosures of for financial instruments as a whole, not just those for which a preparer has elected hedge accounting.

***Issue 10/Question 10: Do you agree with the Board's decision to allow a one-time fair value option at the initial adoption of this proposed Statement? Do you agree with the Board's decision to limit the option to assets and liabilities that are currently designated as hedged items under Statement 133?***

ISDA supports the Board's decision to allow a one-time fair value option at the initial adoption of the proposed Statement; however, we do not believe that the Board should necessarily limit the items that are eligible under this election solely to financial instruments that were designated as hedged items on the date immediately prior to initial application. We do not believe that a company should be required to enter into a hedge relationship immediately prior to transition in order to achieve the ability to elect SFAS 159 at transition solely to obviate a potentially undesirable change to the future accounting for the financial instrument that will arise at transition. We therefore would support an expansion of the one-time fair value option election to financial instruments other than those that are currently designated as hedged item under SFAS 133.

### **Benefit-Cost Considerations**

***Issue 11/Question 11: Do you believe the Board identified the appropriate benefits and costs related to this proposed Statement? If not, what additional benefits or costs should the Board consider?***

ISDA strongly disagrees with the FASB assertion that the costs are justified by the incremental benefits the FASB cites. We do not believe that the financial statements will be more representative of the economics of the instruments designated as accounting hedges or will make it easier to assess the effects of hedging activities. We assert that bringing in unhedged and unhedgeable risks is not representative of the hedging instruments being used or the risk management activities of the enterprise. ISDA does not consider the proposal enhancing comparability or transparency in financial reporting because entities that elect hedge accounting will be subject to partial and arbitrary fair value accounting whereas companies that do not elect hedge accounting will not. Since none of the FASB's perceived benefits are being met, we do not see how the costs can be justified.

In addition, the new proposal does not simplify the hedge accounting that has been in place for over eight years, but instead introduces different complexities. The introduction of long haul accounting for all fixed to floating interest rate hedges will significantly complicate the accounting for simple interest rate hedge transactions, even those done at the inception of the debt instrument. In addition, we believe the proposal will require significant systems changes and will significantly increase costs as firms will need to resolve new interpretive issues on a piecemeal basis between company and auditor, likely also resulting in differences in interpretation and thus reduced comparability.

Finally, any cost/benefit analysis should consider how long these changes will be in place. We again must reiterate that spending scarce resources to make these questionable changes when there may be more changes on the horizon when IFRS is adopted fails to meet the most basic of cost/benefit thresholds. Although SFAS 133 is long and complex, most companies that hedge have already made the investment in meeting its requirements. It would be a significant waste of resources to force a significant change to the hedge accounting rules at this point when the benefits cannot be substantiated.

## **Other Comments**

### **Dedesignation/Redesignation**

#### *General*

Paragraphs 13 through 15 of the Exposure Draft describe the conditions for when an entity can dedesignate a qualifying cash flow or fair value hedging relationship. These paragraphs provide the following.

“A hedging derivative may be effectively terminated by entering into an offsetting derivative instrument. An entity shall document when a derivative is terminated by an offsetting derivative instrument. An entity is not permitted to dedesignate a fair value hedge and discontinue prospectively the accounting specified in paragraphs...of Statement 133 by just removing the designation of the hedging relationship.”

The basis for the FASB’s conclusions that prohibits companies from removing the designation of an accounting hedge states that, “The Board believes that since the economics of the relationship between the hedging instrument and hedged item (forecasted transaction) did not change then the accounting should not change. The Board acknowledges that entities 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. However, the Board does not believe that dedesignation should be used as a tool for changing measurement attributes and/or managing the classification of certain items reported in earnings.”

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, in order to determine what risks should be hedged. Given that hedge accounting needs to be applied at a transaction level, a transaction is selected to represent the portfolio risk 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. Since hedge accounting designations must be made in advance of market movements, we do not understand how an earnings recognition-based intent could ever be realized.

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.

Further, the FASB’s basis for not permitting dedesignation while at the same time acknowledging that a company can achieve a result similar to dedesignating a hedge by terminating the hedging instrument and entering into a new derivative is not fully understandable or explained in the Basis for Conclusions. We strongly recommend the FASB reconsider its decision to prohibit hedge accounting for strategies that necessitate 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 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 clarify whether a derivative designated in a hedge relationship that subsequently fails to meet one the criteria set forth in paragraphs 28 or 29 of SFAS 133 can be redesignated in a new qualifying hedge relationship.

### *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.

### Measurement of Ineffectiveness – Net Investment Hedges

The proposed amendment to the DIG Issue H8, as described in Appendix C of the Exposure Draft, states the following:

“The proposed Statement would require the balance of accumulated other comprehensive income to reflect the cumulative change in the fair value of a derivative that would exactly offset the hedged cash flows when measuring the ineffectiveness of a cash flow hedge. This Issue will be revised to maintain language consistent with that of the proposed Statement.”

ISDA questions the factual accuracy of the proposed amendment to DIG Issue H8 cited above since the net investment hedge accounting model within SFAS 133 is separate and distinct from the cash flow hedge accounting model, and thus warrants a unique approach for measuring ineffectiveness. Though the FASB has not addressed the accounting for net investment hedges in the body of the Exposure Draft, the proposed amendment to DIG Issue H8 suggests otherwise. It clearly indicates that the unique, yet necessary treatment for net investment hedges is being eliminated, including the method for measuring ineffectiveness. As net investment hedges are not designed so that the cash flows of the hedging instrument and the cash flows associated with dividends or the disposition of the hedged net investment match, we disagree with the requirement to calculate ineffectiveness in the same manner prescribed for cash flow hedges. We believe that under the forward method there should be no ineffectiveness if the notional and currency of the portion of the net investment hedged match and that the forward points or option premium should be recorded in CTA until disposition of the net investment. Accordingly, we recommend the FASB to reflect the following modifications to the proposed amendment to DIG Issue H8 within final statement (inserted text is underlined and deleted text is struck).

“The proposed Statement would require the balance of accumulated other comprehensive income to reflect the cumulative change in the fair value of a derivative that would exactly offset the hedged net investment (or portion thereof) cash flows when measuring the ineffectiveness of a net investment cash-flow hedge. This Issue will be revised to maintain language consistent with that of the proposed Statement. When using the forward method, ineffectiveness need not be measured to reflect any difference between the maturity of the hedging instrument and the cash flows from dividends or the disposition of the hedged net investment.”

### Intercompany Transactions

Paragraph 40 of SFAS 133 will be amended as follows.

“However, the requirement in paragraph 29(c) that the forecasted transaction presents an exposure to variations in cash flows that could affect reported earnings must still be met at the level being reported on. (For example, in the financial statements of a consolidated entity, there would need to be a potential earnings effect that survives consolidation.)”

ISDA finds the proposed amendment to paragraph 40 of SFAS 133 unclear in terms of the types of intercompany foreign currency transactions that would continue to be eligible for cash flow hedges in the consolidated financial statements and those that would not be. Thus, if FASB includes this change in a final standard, we strongly recommend that the FASB provide several examples that illustrate the types of hedge relationships that qualify and those that do not qualify based on the proposed amendment to paragraph 40 of SFAS 133.

Though we understand that the amendment is intended to be a clarification of the FASB’s original intent for intercompany foreign currency cash flow hedges, ISDA believes that this change represents a fundamental change to the hedge accounting model, and the FASB’s original decisions as outlined in paragraphs 482 through 484 of SFAS 133’s basis for conclusions.

“482....The Exposure Draft would have required a direct, substantive relationship between the costs incurred and the recovery of those costs from the outside third party. For example, the Exposure Draft would have permitted an English subsidiary that incurs manufacturing costs in pounds sterling to hedge the ultimate sale of that product for French francs by its affiliated French subsidiary to an unrelated third party. *The Board proposed that exception because it considered those transactions to be, in substance, direct foreign export sales.*”

“483. *A number of respondents said that the guidance provided in the Exposure Draft was unduly restrictive because forecasted intercompany royalties and licensing fees, which are based on third-party sales and remitted from foreign subsidiaries to a parent company, would not be afforded cash flow hedge accounting.* Respondents also took exception to the requirement that there be a "direct, substantive relationship" between costs incurred and recovery of those costs.”



“484. *The Board decided to remove the restrictions on hedge accounting for hedges of forecasted intercompany foreign currency transactions because, pursuant to Statement 52 as amended by this Statement, an intercompany transaction that is denominated in a currency other than the entity's functional currency gives rise to a transaction gain or loss if exchange rates change. A forecasted intercompany transaction that is expected to be denominated in a foreign currency can be viewed as giving rise to the same kind of foreign currency risk.* Therefore, pursuant to this Statement, a forecasted intercompany transaction that presents an exposure to foreign currency risk and that otherwise satisfies the criteria for a foreign currency cash flow hedge is eligible for designation as a hedged transaction.” *(emphasis added)*

Our view of the FASB’s consideration of this issue in the original drafting of SFAS 133 is further confirmed in DIG Issue H13, which elaborates on how to apply the Board’s decision to permit hedge accounting for forecasted foreign currency denominated intercompany transactions.

“Paragraph 40 of Statement 133 permits a derivative instrument to be designated as a hedge of the foreign currency exposure of variability in the functional-currency-equivalent cash flow associated with a forecasted intercompany foreign-currency-denominated transaction if certain criteria are met.”

“...in the consolidated financial statements, the amount of OCI representing the effective portion of the gain or loss on a derivative designated as a cash flow hedge of a forecasted foreign-currency-denominated *intercompany sale* should be reclassified into earnings in the period that the revenue from the sale of the manufactured product to an unrelated third party is recognized.” *(emphasis added)*

Based on the above discussion and eight years of subsequent practice, ISDA believes that the FASB Board clearly understood the foreign currency exposure arising from intercompany transactions and the relationship with the ultimate third party revenues and also clearly decided to permit hedge accounting for these exposures. It is on this basis that ISDA believes that the amendment to paragraph 40 is fundamental change to the hedge accounting model.

ISDA believes that such a fundamental change deserves the full deliberation by the Board and opportunity for constituents to understand the Board’s basis for disagreement with paragraphs 482 through 484 of the SFAS 133 Basis for conclusions. Based on the increasing globalization of commerce and insourcing as well as outsourcing to lower cost locations, the foreign currency risks arising from these transactions have only increased in these past eight years. Companies invariably consider their ability to hedge and apply hedge accounting to their foreign currency transactions when making resource allocation decisions. We must highlight that a hedge of either an intercompany foreign currency transaction or an external foreign currency transaction impacts net profit margins in substantially the same manner. We have illustrated several examples supporting the basis for allowing both sets of transactions to qualify in hedge accounting relationships in Appendix C attached. As in any decision that would restrict the ability to manage economic risks, we urge the Board to proceed with due caution in this area. If there is any doubt regarding the original intentions regarding hedgeable intercompany risks and

how this is being applied in practice, this matter should be addressed as part of a separate project that evaluates the cash flow hedge accounting model together with SFAS 52.

### Reasonably Effective Criterion

Paragraph A9 of the Exposure Draft provides the following basis for not defining *reasonably effective*.

“A9. 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 A9 (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 purpose 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 A9 to be struck in their entirety from a final standard.

### Measurement of Ineffectiveness in a Cash Flow Hedge Relationship

Paragraph 24 of the Exposure Draft provides that, “Accumulated other comprehensive income associated with the hedged transaction shall be adjusted 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 hedged less the amount previously reclassified from accumulated other comprehensive income into earnings, if any.” This proposed requirement will result in the recognition of ineffectiveness in current earnings due to both under-hedging and over-hedging, which is significant change to current practice. 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 because there is no conceptual basis for providing special hedge accounting for cash flow hedges other than to achieve a synthetic instrument accounting result in the income statement.”

The FASB’s Basis for conclusions does not address why this fundamental change from SFAS 133 is an improvement to financial reporting, results in simplification, and further does not address the change in the conclusion the FASB reached when it issued SFAS 133. In paragraphs 379 and 380 of SFAS 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 SFAS 133 should be made without a more robust justification that directly addresses how reporting these nonexistent gains and losses in OCI and earnings provides more transparent financial statements, and achieves the appropriate cost-benefit conclusion.

### Delta Hedging

Paragraphs 13 through 15 of the Exposure Draft describe the conditions for when an entity can dedesignate a qualifying cash flow or fair value hedging relationship and prohibit companies from terminating a hedge simply by removing the designation. As noted in our comment on dedesignation above, many common hedging strategies used in practice employ hedge dedesignation that would be inconsistent with paragraph 13 of the Exposure Draft, possibly including delta neutral hedging strategies. However, the example of a delta neutral hedging strategy illustrated in paragraphs 86 and 87 of SFAS 133 has not been revised in a manner consistent with paragraph 13 of the Exposure Draft and thus leads us to question the application of the Exposure Draft’s dedesignation provisions to delta neutral hedging strategies.

In a typical delta neutral hedging strategy, the quantity or notional of derivatives over the life of the hedge is changed as the hedged item’s delta changes. Since some practitioners currently view a change in the quantity or notional of the derivatives used in a delta neutral hedge strategy as the termination of the existing hedging relationship, we are unclear how such a strategy would be permitted in light of the amendments proposed in paragraphs 13 and 15 of the Exposure Draft. Specifically, it is unclear whether the addition or removal of derivatives to maintain a delta neutral hedge ratio would be treated as a termination of the hedge relationship under the Exposure Draft. As such, we strongly encourage the FASB to clarify whether a delta neutral hedging strategy would continue to be permitted under the proposed amendments and, if so, to illustrate how such a strategy would be implemented in a manner that meets the conditions of paragraphs 13 and 15 of the Exposure Draft by amending paragraphs 86 and 87 of SFAS 133.

Clarification of When Own Debt Qualifies for a Benchmark Interest Rate Hedge

Paragraph 17 of the Exposure Draft permits a company to designate its own issued debt in a hedge of a benchmark interest rate if the hedge begins at the inception of the debt or within a reasonably short period of time after recognition of the debt. ISDA believes that if the Board goes forward and issues the Exposure Draft as final, this provision should be included as part of the amendments to paragraphs 21g and 29i and recommends that the following modifications be made to SFAS 133 (text inserted is underlined).

21g. If the hedged item is the recognized liability for an entity's own issued debt or other borrowing, including debt assumed in a business combination, the designated risk being hedged is:

- (1) The risk of changes in the overall fair value of the entire hedged item,
- (2) The risk of changes in its fair value attributable to changes in the **designated benchmark interest rate** (referred to as interest rate risk), (3) The risk of changes in its fair value attributable to foreign exchange risk, or
- (4) The risk of changes in its fair value attributable to both interest rate risk and foreign exchange risk.

Designating only interest rate risk, or only a combination of interest rate risk and foreign exchange risk as the hedged risk is permitted only at inception of the debt, or within a reasonably short period of time after recognition of the debt. (For debt assumed in a business combination, inception of the debt would be the acquisition date.)

**Appendix B: Illustration of Common Hedges under the Proposed Overall Change in Fair Value Approach**

The following examples highlight the application of the FASB’s proposed overall changes in fair value approach to two fair value hedge accounting relationships involving a company’s own debt. The effectiveness conclusions are equally applicable to overall cash flow hedges using interest rate swaps.

**Example # 1: Fair Value Hedge of Fixed-Rate High Credit Quality Debt (with Stable Credit Spreads)**

**Background**

This example illustrates the results of a hedge of the overall changes in fair value of \$100 million, 10-year fixed-rate debt for 30 months (based on actual market data) using a LIBOR-based interest rate swap as the hedging instrument.

This examples illustrates the consequences of eliminating bifurcation-by-risk for late hedges, forecasted debt issuances, and hedges of financial assets. In this example, ISDA applied the FASB's overall change in fair value approach to a fair value hedge of fixed-rate debt issued by a borrower of high credit quality with relatively stable credit spreads.

Valuation of the hedged item was performed using publicly available credit default swap data for the issuer.

Key Terms	Swap	Debt
Notional/Principal	100,000,000	100,000,000
Start Date	12/31/2005	12/31/2005
Maturity Date	12/31/2015	12/31/2015
Fixed Rate	4.91%	5.26%
Initial Credit Spread	N/A	0.35%

Issuer's Credit Ratings	
Moody's	Aa2
S&P	AA-
Fitch	Aa-

Summary of Results - Example #1												
Measurement Date	Swap Clean Price (\$US)	Credit Spread (bps)	Change in Credit Spread (bps)	Debt Value (Based on Changes in Rates)	Add'l Adjust. to Debt Value for Changes in Credit Spreads	Full Fair Value of Debt (rates + spreads) (\$US)	Change in FV of Swap (\$US)	Change in FV of Debt due to Rates (\$US)	Dollar Offset % (changes in rates)	Change in Total FV of Debt (\$US)	Periodic Dollar Amount of Ineffectiveness (\$US)	Periodic Dollar Offset %
12/31/05	-	35	----	(100,000,000)	----	(100,000,000)	----	----	----	----	----	----
1/31/06	(718,395)	38	3	(99,332,072)	188,184	(99,143,888)	(718,395)	667,928	-108%	856,112	(137,717)	-84%
2/28/06	(1,020,548)	32	(6)	(99,031,602)	(252,149)	(99,283,750)	(302,153)	300,471	-101%	(139,862)	442,015	216%
3/31/06	(3,391,304)	31	(1)	(96,736,774)	(303,847)	(97,040,621)	(2,370,756)	2,294,828	-103%	2,243,129	127,626	-106%
4/30/06	(4,639,322)	30	(2)	(95,472,895)	(416,370)	(95,889,265)	(1,248,019)	1,263,879	-99%	1,151,356	96,662	-108%
5/31/06	(5,398,174)	29	(1)	(94,723,866)	(443,953)	(95,167,819)	(758,851)	749,029	-101%	721,446	37,405	-105%
6/30/06	(5,698,920)	29	-	(94,466,511)	(438,715)	(94,905,226)	(300,747)	257,354	-117%	262,593	38,154	-115%
7/31/06	(4,328,318)	28	(1)	(95,803,775)	(531,069)	(96,334,843)	1,370,602	(1,337,264)	-102%	(1,429,617)	59,015	-96%
8/31/06	(2,519,522)	25	(3)	(97,628,149)	(751,783)	(98,379,932)	1,808,796	(1,824,375)	-99%	(2,045,089)	236,293	-88%
9/30/06	(1,620,385)	24	(1)	(98,466,202)	(808,425)	(99,274,627)	899,137	(838,053)	-107%	(894,695)	(4,442)	-100%
10/31/06	(1,320,181)	23	(1)	(98,752,512)	(876,648)	(99,629,160)	300,204	(286,309)	-105%	(354,533)	54,329	-85%
11/30/06	68,142	24	1	(100,152,098)	(812,378)	(100,964,475)	1,388,323	(1,399,586)	-99%	(1,335,315)	(53,008)	-104%
12/31/06	(1,595,266)	25	1	(98,491,631)	(721,042)	(99,212,673)	(1,663,408)	1,660,466	-100%	1,751,802	(88,394)	-95%
1/31/07	(3,023,343)	25	(1)	(97,075,862)	(737,555)	(97,813,417)	(1,428,077)	1,415,769	-101%	1,399,256	28,821	-102%
2/28/07	(922,146)	28	3	(99,142,462)	(526,481)	(99,668,944)	2,101,197	(2,066,600)	-102%	(1,855,527)	(245,670)	-113%
3/31/07	(1,377,571)	29	1	(98,709,468)	(455,438)	(99,164,906)	(455,425)	432,994	-105%	504,038	(48,613)	-90%
4/30/07	(1,274,539)	24	(5)	(98,797,561)	(785,916)	(99,583,477)	103,032	(88,093)	-117%	(418,571)	315,539	-25%
5/31/07	(3,346,386)	24	1	(96,783,124)	(719,574)	(97,502,698)	(2,071,847)	2,014,437	-103%	2,080,779	(8,932)	-100%
6/30/07	(4,626,388)	29	5	(95,494,539)	(389,352)	(95,883,891)	(1,280,001)	1,288,585	-99%	1,618,807	(338,806)	-79%
7/31/07	(3,276,014)	55	26	(96,825,161)	1,281,773	(95,543,388)	1,350,374	(1,330,622)	-101%	340,503	(1,690,877)	397%
8/31/07	(1,471,936)	47	(8)	(98,613,912)	769,337	(97,844,575)	1,804,078	(1,788,751)	-101%	(2,301,188)	497,110	-78%
9/30/07	(1,177,222)	39	(9)	(98,903,636)	203,449	(98,700,188)	294,714	(289,724)	-102%	(855,612)	560,898	-34%
10/31/07	(552,044)	43	4	(99,566,916)	463,117	(99,103,799)	625,178	(663,279)	-94%	(403,611)	(221,567)	-155%
11/30/07	3,168,169	53	11	(103,192,351)	1,203,944	(101,988,407)	3,720,214	(3,625,436)	-103%	(2,884,609)	(835,605)	-129%
12/31/07	2,842,718	58	4	(102,832,561)	1,474,240	(101,358,321)	(325,452)	359,790	-90%	630,087	(304,635)	-52%
1/31/08	6,086,439	71	13	(106,327,775)	2,405,533	(103,922,242)	3,243,721	(3,495,214)	-93%	(2,563,921)	(679,800)	-127%
2/29/08	6,683,951	96	25	(106,778,656)	4,098,588	(102,680,069)	597,512	(450,881)	-133%	1,242,173	(1,839,685)	48%
3/31/08	7,581,516	100	4	(107,531,920)	4,372,101	(103,159,819)	897,565	(753,264)	-119%	(479,750)	(417,814)	-187%
4/30/08	5,161,818	70	(30)	(105,110,804)	2,270,035	(102,840,769)	(2,419,698)	2,421,116	-100%	319,050	2,100,648	-758%
5/31/08	2,675,146	78	8	(102,685,384)	2,684,585	(100,000,798)	(2,486,672)	2,425,421	-103%	2,839,970	(353,298)	-88%
6/30/08	2,749,563	106	28	(102,753,886)	4,353,576	(98,400,310)	74,418	(68,503)	-109%	1,600,489	(1,674,907)	5%
							2,749,563	(2,753,886)			(4,349,254)	

Net ineffectiveness: (4,323)

Example #1 Regression Results (Overall Changes in Fair Value)		Indicative of Reasonably Effective/Passed?
R-Squared	0.794	Yes
Slope	(0.945)	Yes
F-Stat	108	Yes

Example #1 Regression Results (Changes in LIBOR)		Indicative of Reasonably Effective/Passed?
R-Squared	0.998	Yes
Slope	(1.004)	Yes
F-Stat	14,716	Yes

**Example # 1 Conclusions:**

This example illustrates the consequences of eliminating bifurcation-by-risk.

Regression statistics and dollar offset results are very strong for hedges of the benchmark interest rate only. The regression statistics and dollar offset results for when the hedged risk is designated as overall changes in fair value are much worse than for a hedge of benchmark interest rate risk only. The cumulative income statement impact is a gain of \$4.3 million under an overall changes in fair value approach compared to a loss of only \$0.004 million for a hedge of interest rate risk only.

Further, cells highlighted above indicate periods when changes in fair value of swap and debt are positively correlated in the overall fair value designation. Effective hedges must be negatively correlated.

Based on a "reasonably effective" standard, this hedging relationship would likely qualify for hedge accounting using regression, although the last 12 months show significant deterioration in the effectiveness of the hedging relationship for overall changes in fair value due to volatility in the issuer's credit spread.

Dollar offset percentage for overall changes in fair value would fail even a "reasonably effective" standard in some periods, thereby requiring preparers to use regression, and adding to the complexity required for quantitative assessments.

**Example #2: Fair Value Hedge of Fixed-Rate Lower Credit Quality Debt (with Unstable Credit Spreads)**

**Background**

This example illustrates the results of the overall changes in fair value of \$100 million, 10-year, fixed-rate debt for 30 months (based on actual market data) using a LIBOR-based interest rate swap as the hedging instrument.

This example illustrates the consequences of eliminating bifurcation-by-risk for late hedges, forecasted debt issuances, and hedges of financial assets. In this example, ISDA applied the FASB's overall change in fair value approach to a fair value hedge of fixed-rate debt issued by a borrower with a lower investment grade credit rating with relatively unstable credit spreads.

Valuation of the hedged item was performed using publicly available credit default swap data for the issuer.

Key Terms	Swap	Debt
Notional/Principal	100,000,000	100,000,000
Start Date	12/31/2005	12/31/2005
Maturity Date	12/31/2015	12/31/2015
Fixed Rate	4.91%	5.73%
Initial Credit Spread	N/A	0.82%

Issuer's Credit Ratings	
Moody's	Baa3
S&P	BBB
Fitch	BBB-



Summary of Results - Example #2												
Measurement Date	Swap Clean Price (\$US)	Credit Spread (bps)	Change in Credit Spread (bps)	Debt Value (Based on Changes in Rates)	Add'l Adjust. to Debt Value for Changes in Credit Spreads	Full Fair Value of Debt (rates + spreads) (\$US)	Change in FV of Swap (\$US)	Change in FV of Debt due to Rates (\$US)	Dollar Offset % (changes in rates)	Change in Total FV of Debt (\$US)	Periodic Dollar Amount of Ineffectiveness (\$US)	Periodic Dollar Offset %
12/31/05	-	82	----	(100,000,000)		(100,000,000)	----	----	----	----	----	----
1/31/06	(718,395)	77	(5)	(99,398,353)	(369,534)	(99,767,888)	(718,395)	601,647	-119%	232,112	486,283	-310%
2/28/06	(1,020,548)	67	(10)	(99,101,976)	(1,100,921)	(100,202,898)	(302,153)	296,377	-102%	(435,010)	737,163	69%
3/31/06	(3,391,304)	71	4	(96,855,636)	(779,648)	(97,635,284)	(2,370,756)	2,246,340	-106%	2,567,614	(196,858)	-92%
4/30/06	(4,639,322)	63	(8)	(95,615,063)	(1,325,360)	(96,940,423)	(1,248,019)	1,240,573	-101%	694,861	553,158	-180%
5/31/06	(5,398,174)	66	3	(94,880,548)	(1,074,612)	(95,955,160)	(758,851)	734,515	-103%	985,263	(226,412)	-77%
6/30/06	(5,698,920)	72	6	(94,628,888)	(688,350)	(95,317,238)	(300,747)	251,660	-120%	637,923	(337,176)	-47%
7/31/06	(4,328,318)	68	(4)	(95,936,938)	(957,351)	(96,894,289)	1,370,602	(1,308,050)	-105%	(1,577,051)	206,449	-87%
8/31/06	(2,519,522)	66	(3)	(97,727,652)	(1,146,149)	(98,873,801)	1,808,796	(1,790,714)	-101%	(1,979,512)	170,716	-91%
9/30/06	(1,620,385)	68	2	(98,543,661)	(1,010,524)	(99,554,184)	899,137	(816,008)	-110%	(680,384)	(218,753)	-132%
10/31/06	(1,320,181)	62	(6)	(98,823,713)	(1,392,234)	(100,215,947)	300,204	(280,053)	-107%	(661,762)	361,559	-45%
11/30/06	68,142	63	1	(100,197,910)	(1,368,717)	(101,566,627)	1,388,323	(1,374,197)	-101%	(1,350,680)	(37,643)	-103%
12/31/06	(1,595,266)	69	7	(98,568,011)	(872,399)	(99,440,409)	(1,663,408)	1,629,899	-102%	2,126,218	(462,810)	-78%
1/31/07	(3,023,343)	76	7	(97,179,618)	(411,283)	(97,590,902)	(1,428,077)	1,388,393	-103%	1,849,508	(421,431)	-77%
2/28/07	(922,146)	71	(5)	(99,203,333)	(745,179)	(99,948,512)	2,101,197	(2,023,715)	-104%	(2,357,610)	256,413	-89%
3/31/07	(1,377,571)	86	15	(98,778,833)	246,304	(98,532,529)	(455,425)	424,499	-107%	1,415,982	(960,557)	-32%
4/30/07	(1,274,539)	82	(4)	(98,863,863)	-	(98,863,863)	103,032	(85,029)	-121%	(331,333)	228,301	-31%
5/31/07	(3,346,386)	84	2	(96,890,583)	127,920	(96,762,663)	(2,071,847)	1,973,279	-105%	2,101,199	(29,352)	-99%
6/30/07	(4,626,388)	88	4	(95,622,393)	375,246	(95,247,147)	(1,280,001)	1,268,190	-101%	1,515,516	(235,515)	-84%
7/31/07	(3,276,014)	167	79	(96,927,732)	5,205,482	(91,722,250)	1,350,374	(1,305,339)	-103%	3,524,897	(4,875,271)	38%
8/31/07	(1,471,936)	213	46	(98,685,173)	7,986,510	(90,698,662)	1,804,078	(1,757,440)	-103%	1,023,588	(2,827,666)	176%
9/30/07	(1,177,222)	253	40	(98,966,187)	10,253,091	(88,713,097)	294,714	(281,015)	-105%	1,985,565	(2,280,280)	15%
10/31/07	(552,044)	268	15	(99,616,990)	11,086,319	(88,530,671)	625,178	(650,802)	-96%	182,426	(807,604)	343%
11/30/07	3,168,169	311	44	(103,176,504)	13,930,732	(89,245,773)	3,720,214	(3,559,515)	-105%	(715,102)	(3,005,112)	-520%
12/31/07	2,842,718	281	(31)	(102,823,177)	12,119,154	(90,704,023)	(325,452)	353,327	-92%	(1,458,251)	1,783,703	22%
1/31/08	6,086,439	362	82	(106,256,901)	17,167,250	(89,089,650)	3,243,721	(3,433,723)	-94%	1,614,373	(4,858,094)	201%
2/29/08	6,683,951	733	370	(106,696,003)	35,026,229	(71,669,773)	597,512	(439,102)	-136%	17,419,877	(18,017,389)	3%
3/31/08	7,581,516	754	21	(107,435,083)	35,934,080	(71,501,003)	897,565	(739,081)	-121%	168,770	(1,066,335)	532%
4/30/08	5,161,818	365	(389)	(105,058,620)	16,690,928	(88,367,692)	(2,419,698)	2,376,463	-102%	(16,866,689)	19,286,387	14%
5/31/08	2,675,146	326	(39)	(102,677,527)	14,072,241	(88,605,286)	(2,486,672)	2,381,093	-104%	(237,594)	2,724,266	1047%
6/30/08	2,749,563	610	284	(102,744,842)	27,388,822	(75,356,020)	74,418	(67,315)	-111%	13,249,266	(13,323,684)	1%
							2,749,563	(2,744,842)	-100%		(27,393,543)	

Net ineffectiveness: 4,722

Example #2 Regression Results (Overall Changes in Fair Value)		Indicative of Reasonably Effective/Passed?
R-Squared	0.012	No
Slope	0.033	No
F-Stat	0.332	No

Example #2 Regression Results (Changes in LIBOR)		Indicative of Reasonably Effective/Passed?
R-Squared	0.998	Yes
Slope	(1.023)	Yes
F-Stat	13,410	Yes

**Example # 2 Conclusions:**

Regression statistics and dollar offset results are very strong for hedges of the benchmark interest rate only. However, the regression statistics and dollar offset results for when the hedged risk is designated as overall changes in fair value show little to no negative correlation (there is actually positive correlation in many cases). The results of hedging the overall changes in fair value do not resemble the results that would occur in a hedge of the benchmark interest rate risk only.

Cells highlighted above indicate periods when changes in fair value of swap and debt are positively correlated in the overall fair value designation. Effective hedges must be negatively correlated.

For hedges of overall changes in fair value, this hedge would not qualify for hedge accounting under any reasonable interpretation of "reasonably effective." While this issuer's debt is rated investment grade, the instability of its credit spread over the period of this hedge is the primary driver of the failure to be reasonably effective. Therefore, ISDA generally believes that regardless of their credit rating (including investment grade borrowers), companies with unstable credit spreads will find it difficult for their debt hedges to achieve the "reasonably effective" criterion.

Income statement volatility is significant (gains of about \$27.4 million during the period). Most of that volatility occurs during the last 12 months of the hedge relationship and is due to more significant changes in the issuer's credit spread.

**Appendix C: Common Hedges of Foreign Currency Denominated, Intercompany Transactions**

**Background:**

The examples below illustrate several common foreign currency denominated, intercompany transactions that companies hedge and designated in SFAS 133 hedge accounting relationships, most, if not all, would be ineligible for hedge accounting pursuant to the proposed amendment to paragraph 40 of SFAS 133. For certain of these examples, we have included comparable third party transactions that would be eligible for hedge accounting pursuant to the Exposure Draft to highlight the merits of permitting hedge accounting for both sets of transactions.

<b>Hedge Strategy</b>
<p><b>Example #1(a): Foreign Currency Denominated Intercompany Royalties (based on external sales)</b></p> <p>U.S. functional currency parent has various international operating subsidiaries whose functional currencies are the same as their local currencies. The parent licenses its own intellectual property to its subsidiaries for their use of that intellectual property in the production of goods/services ultimately sold to third parties. The parent invoices its subsidiaries on a quarterly basis for royalties due for their use of the intellectual property based on actual third-party sales recorded during the period. The intercompany invoices are denominated in the same currency as the subsidiaries' local/functional currencies. The parent designates the variability of functional currency equivalent cash flows attributed to changes in foreign currency exchange rates between the U.S. Dollar and the currency in which the intercompany royalties are invoiced as a cash flow hedge under SFAS 133.</p> <p>Under the Exposure Draft the parent company would not be permitted to apply hedge accounting to its forecasted intercompany royalty revenues at the consolidated level; also the subsidiaries could not hedge the forecasted intercompany royalties (even if denominated in a foreign currency), as the forecasted intercompany royalties would be eliminated in consolidation and do not affect earnings.</p>
<p><b>Example 1(b): Foreign Currency Denominated Intercompany Royalties (based on fixed amount per year)</b></p> <p>U.S. functional currency parent has various international operating subsidiaries whose functional currencies are the same as their local currencies. The parent licenses its own intellectual property to its subsidiaries for their use of that intellectual property in the production of goods/services ultimately sold to third parties. The parent invoices its subsidiaries on a quarterly basis for a royalties based on a fixed amount per year (amount is established at the beginning of each fiscal year) for their use of the intellectual property. The intercompany invoices are denominated in the same currency as the subsidiaries' local/functional currencies. The parent designates the variability of functional currency equivalent cash flows attributed to changes in foreign currency exchange rates between the U.S. Dollar and the currency in which the intercompany royalties are invoiced as a cash flow hedge under SFAS 133.</p> <p>Under the Exposure Draft the parent company would not be permitted to apply hedge accounting to its forecasted intercompany royalty revenues at the consolidated level; also the subsidiaries could not hedge the forecasted intercompany royalties (even if denominated in a foreign currency) as the forecasted intercompany royalties would be eliminated in consolidation and do not affect earnings.</p>
<p><b>Example #2: Intercompany Sales of Inventory</b></p> <p>U.S. functional currency parent sells raw materials (denominated in U.S. Dollars) to a Euro functional currency manufacturing subsidiary in located in Europe. Manufacturing subsidiary produces products and sells products to the parent company's sales subsidiaries throughout Europe and globally in the sales subsidiaries' local currencies. Sales subs sell to third party customers. European manufacturing subsidiary hedges the USD cost of the purchase of raw materials from the parent as well as its foreign currency denominated sales.</p> <p>Under the Exposure Draft the manufacturing subsidiary would not be permitted to apply hedge accounting to its forecasted intercompany purchases from its parent as the transactions would be eliminated in consolidation and do not</p>

affect earnings. However, the foreign sales subsidiaries would be permitted to hedge third-party sales to the extent denominated in foreign currencies, which could provide the same economic result in the consolidated financial statements as the a hedge entered into by manufacturing subsidiary (assuming the same currencies (U.S. Dollar and Euro) are involved).

Other variations of the fact pattern above that are common include:

*Hedge of forecasted intercompany foreign currency denominated sales (functional currency denominated expenses, foreign currency sales)*

- U.S. functional currency parent markets and sells products (in U.S. Dollars) that are manufactured by several consolidated manufacturing subsidiaries domiciled in various international locations. The manufacturing subsidiaries, whose functional currencies are the same as their local currencies, sell their products to the parent company's sales subsidiaries located in various countries and bill these intercompany sales in the sales subsidiaries' local currencies (using spot exchange rates). The manufacturing subsidiaries designate their forecasted, intercompany foreign currency denominated sales in cash flow hedges under SFAS 133.

Under the Exposure Draft the manufacturing subsidiaries would not be permitted to apply hedge accounting to their forecasted, intercompany sales to the parent's sales subsidiaries, as the transactions would be eliminated in consolidation and do not affect earnings. However, the foreign sales subsidiaries would be permitted to hedge third-party sales to the extent denominated in foreign currencies, which could provide the same economic result in the consolidate financial statements as the a hedge entered into by manufacturing subsidiary (assuming the same currencies are involved).

*Hedge of forecasted intercompany foreign currency denominated sales (functional currency denominated expenses, foreign currency sales)*

- European-based, U.S. functional currency manufacturing subsidiary of a U.S. parent company manufactures products for the parent's third-party customers located in various international locations. The components and costs to produce end products sold to customers are predominantly based in U.S. Dollars. The customers manage their inventory on a just-in-time basis and place sales orders through the parent's sales subsidiaries. Each sales subsidiary's functional currency is the same as its local currency, and sales to third party customers are denominated in the respective subsidiary's functional currency (using spot exchange rates). The manufacturing subsidiary sells completed products to the sales subsidiaries in their local currencies and thus the manufacturing subsidiary designates the intercompany foreign currency denominated sales in cash flow hedges under SFAS 133.

Under the Exposure Draft the manufacturing subsidiary would not be permitted to apply hedge accounting to their forecasted, intercompany sales to the sales subsidiaries, as the transactions would be eliminated in consolidation and do not affect earnings. Unless the sales subsidiaries had foreign currency sales, none of these transactions would qualify for hedge accounting under the Exposure Draft.

*Hedge of forecasted intercompany foreign currency denominated sales (foreign currency denominated cost of goods sold, foreign currency sales)*

- U.S. functional currency entity has U.S. functional currency regional sales offices in Europe, Asia, and Latin America (generally low-tax jurisdictions within these regions). The sales offices purchase products from manufacturing subsidiaries within the consolidated group or external suppliers (which ever provides the lowest transfer price) in the supplier's local currency. The regional sales offices then sell these products to sales subsidiaries in their local currency for ultimate sales to external third parties (in local currency). The regional sales office designates the intercompany foreign currency denominated sales to the sales subsidiaries in cash flow hedges under SFAS 133.

Under the Exposure Draft only foreign currency sales directly from the sale office to the third party customers or the regional sales offices' foreign currency purchases from the third party suppliers would qualify for hedge accounting.

