

November 4, 2016

Ms. Susan M. Cospers
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
By email: director@fasb.org

Re: File Reference Number 2016-310, Exposure Draft, *Derivatives and Hedging (Topic 815) – Targeted Improvements to Accounting for Hedging Activities*

Dear Ms. Cospers,

The International Swaps and Derivatives Association's (ISDA)¹ Accounting Policy Committee appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB") Exposure Draft, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities* (the "Exposure Draft"). Collectively, the Committee members have substantial professional expertise and practical experience addressing accounting policy issues related to financial instruments and specifically derivative financial instruments. This letter provides our organization's overall views on the Exposure Draft and our responses to the questions for respondents included within the Exposure Draft.

Overview

ISDA supports the FASB's efforts to simplify the accounting for hedging activities and address practice issues that have arisen under current generally accepted accounting principles ("GAAP"). We believe the Exposure Draft achieves the FASB's objectives of improving the financial reporting of cash flow and fair value hedge relationships to better portray the economic results of an entity's risk management activities in its financial statements and simplifying the application of hedge accounting guidance in current GAAP.

¹ Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. Today, ISDA has over 850 member institutions from 67 countries. These members comprise of a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

In particular, ISDA is supportive of the following targeted improvements (among others):

- For cash flow hedges of nonfinancial assets, the ability to designate the hedged risk as the variability in cash flows attributable to changes in a contractually specified component stated in the contract
- For cash flow hedges of interest rate risk of variable-rate financial instruments, the ability to designate the hedged risk as the variability in cash flows attributable to a contractually specified interest rate
- For fair value hedges of interest rate risk, the ability to hedge the Securities Industry and Financial Markets Association (SIFMA) index as an eligible benchmark interest rate
- For fair value hedges of interest rate risk, allowing an entity to hedge partial-terms by assuming the hedged item has a term that reflects only the designated cash flows being hedged
- Permitting an entity the election to measure the change in fair value of a hedged item on the basis of the benchmark rate component of the contractual coupon cash flows determined at hedge inception, rather than on the full contractual coupon cash flows (except in certain circumstances)
- Amendments regarding the recognition and presentation of the effects of hedging instruments, except as noted in our comments and responses below
- Providing an entity additional time to perform the initial prospective quantitative assessment
- For certain hedges, allowing an entity to perform subsequent assessments of hedge effectiveness qualitatively, unless facts and circumstances change
- For purposes of assessing whether the qualifying criteria for the “critical terms match” method are met for a group of forecasted transactions, allowing an entity to assume that the hedging derivative matures at the same time as the group of forecasted transactions in certain circumstances
- Permitting an entity to apply a pre-selected long-haul method to assess hedge effectiveness if an entity determines that it inappropriately used the shortcut method, as long as the hedge is highly effective and the entity documents the long-haul methodology at hedge designation

In addition to our responses to the Questions for Respondents posed in the Exposure Draft, we believe there are aspects of the Exposure Draft that would benefit from additional clarification to avoid misapplication of the guidance or other unintended consequences. As such, we provide the following comments that do not align with any of the specific questions.

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Comments for Clarification

31-Day Practical Expedient for Critical Terms Match Method

The Exposure Draft states in ASC 815-20-25-84A that an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity of the hedging instrument match if those forecasted transactions occur within the same 31-day period as the maturity of the derivative. It is not clear if the Board’s decision was to afford this flexibility only to “forecasted purchases and sales” (as stated in paragraph BC140), or if this guidance also applies to other types of transactions (e.g., forecasted variable interest payments on financial instruments).

Our members do not believe there is any conceptual basis to distinguish between forecasted purchases and sales and other forecasted transactions that are exposed to variability, including payments and receipts of interest associated with financial assets and liabilities. Therefore, we encourage the Board to clarify that the 31-day day practical expedient is applicable to all such forecasted transactions.

Partial-Term Cash Flow Hedges

When hedging the variability of forecasted variable-rate interest rate payments, there is diversity in practice regarding how an entity determines the hypothetically perfect derivative that will be used to assess hedge effectiveness when an entity hedges less than the full tenor of the hedged item. For example, an entity may seek to hedge interest rate risk for the first 5 years of a 10-year debt issuance by entering into a forward-starting, pay-fixed, receive-variable interest rate swap with a notional that matches the expected debt principal and a tenor of 5 years. In this scenario, diversity in practice exists on how to represent the hypothetically perfect derivative, as some entities may determine the fixed rate of the hypothetically perfect derivative by reference to the 5-year swap rate (the tenor of the hedged cash flows), while others may determine the fixed rate by reference to the 10-year swap rate (the tenor of the debt).

The Exposure Draft will permit an entity to identify selected cash flows associated with a fixed-rate debt instrument that coincide with the term of a designated interest rate swap as the hedged item in a fair value hedge of interest rate risk (a “partial-term hedge”). Since ASC Topic 815 will also continue to permit the hedging of selected probable, forecasted variable interest payments in a cash flow hedge of interest rate risk, we recommend that the FASB incorporate conforming partial-term hedge guidance into the cash flow hedge guidance as follows:

(proposed edits to the text are underlined).

815-20-25-13 An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with either of the following:

- a. An existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt)
- b. A forecasted transaction (such as a forecasted purchase or sale, or all or selected future interest payments on a forecasted debt issuance).

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815-20-55-33G For a cash flow hedge of interest rate risk in which the hedged item is designated as selected interest payments associated with a probable, forecasted debt issuance (whether fixed-rate or floating-rate) in accordance with paragraph 815-20-25-13(b), the entity may determine the fair value of the hedged item (whether measured in accordance with the guidance in paragraph 815-30-35-25 through 35-29 or otherwise) based on an assumed term that begins with the first probable hedged cash flow and ends with the last probable hedged cash flow (based on a term structure of interest rates that reflects such tenor).

Treatment of Other Comprehensive Income for an Off-market Swap Designated in a Cash Flow Hedge

Proposed paragraph ASC 815-30-35-41A states that “*an entity may designate a hedging derivative with periodic cash settlements and a non-zero fair value at hedge inception as the hedging instrument in a qualifying cash flow hedging relationship. In this situation, amounts related to the **initial** fair value that are recorded in other comprehensive income during the hedging relationship shall be reclassified from accumulated other comprehensive income to earnings on a systematic and rational basis over the periods during which the hedged forecasted transactions affect earnings.*” [Emphasis added]

ISDA believes the word “initial” (emphasized above) should be deleted from the above paragraph, as the changes in the hedging instrument’s fair value that will flow through other comprehensive income over time will include changes in the initial fair value. Also, the above proposed paragraph appears to ascribe a view that the entire off-market component of the swap will flow through OCI and should be amortized into earnings, including any change in fair value associated with the off-market component. However, ISDA believes that other approaches may also be acceptable to derive the same result. For example, as illustrated in Appendix A, interest expense could be recorded based on the “at-market” rate on the date of designation, with the difference between discounted and undiscounted cash flows at hedge inception amortized as an adjustment to interest expense.

Disclosures

In addition to our response to Question 7 regarding disclosures, the Board’s proposed edit to paragraph ASC 815-10-50-4F references paragraph 50-4C, which, as amended, only addresses qualifying fair value and cash flow hedges. This appears to be a typographical error, as it seems that the reference should be to paragraph 50-4CC, given that this new paragraph focuses on derivatives not designated or qualifying as hedging instruments.

Consistent Use of Hedge Effectiveness Methods

Paragraphs 815-20-25-81 and 815-20-35-2B of the Exposure Draft require an entity to assess hedge effectiveness for similar hedges in a similar manner, and that variation in hedge effectiveness methodologies across similar hedges be justified. This restriction includes an entity’s decisions to exclude components from the assessment of hedge effectiveness (e.g., time value of a foreign exchange forward contract) and to assess hedge effectiveness subsequent to hedge inception using a qualitative method.

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The requirement in paragraph 815-20-25-81 to use consistent methods to assess hedge effectiveness and include similar derivative components has existed since the original issuance of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, while the requirement in paragraph 815-20-35-2B is part of the proposed updates to ASC Topic 815. However, retention and addition of these restrictions in any final guidance seems counter to the Board's objective of simplifying the application of hedge accounting guidance. Specifically, it is not clear why this requirement for consistency is necessary, given the following:

- The use of different assessment methodologies for similar hedges (e.g., hedges of interest rate risk) may be warranted because the individual hedge relationships embody different attributes. For example, an entity that is hedging exposure to variability in LIBOR associated with interest payments on a variable-rate term loan may use an at-market, pay fixed, receive LIBOR interest rate swap and conclude the hedge is perfectly effective because of critical terms matching, and thus elect to use a variation of the critical-terms-match method described in paragraphs 815-30-35-25 through 35-29 (the hypothetical derivative method) to qualitatively assess hedge effectiveness. In contrast, an entity may hedge exposure to variability in the same risk arising from the same type of loan but use an interest rate swap that is off-market at hedge inception. In the latter case, the entity may wish to use regression analysis to demonstrate that the hedge is highly effective.
- ASC Topic 815 neither prescribes nor proscribes specific methods of assessing hedge effectiveness; it only requires that the method be reasonable. Accordingly, ISDA questions why use of similar hedge effectiveness assessment methods for similar hedges would lead to an improvement in financial reporting relative to use of other reasonable (yet different) methods of assessing hedge effectiveness for similar hedging strategies.
- When the FASB Emerging Issues Task Force (EITF) deliberated changes to the definition of a benchmark interest rate in 2013, which culminated in the issuance of ASU 2013-10, *Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes*, it decided to eliminate similar restrictive language that required entities to designate the same benchmark interest rate for similar hedges. The EITF's basis for reaching this conclusion was that risk may differ for a similar financial asset, financial liability, or forecasted transaction depending on how that hedged item is used within the organization and the risk manager's objective in hedging its respective interest rate risk.
- Under the Exposure Draft, BC117 states, in part, "...the Board decided that an entity could use either the total coupon cash flows or benchmark rate coupon cash flows" when determining the change in fair value of a hedged item attributable to interest rate risk, which we understand to be an election available for individual hedge relationships, as there is no proposed requirement that an entity must make an accounting policy election to use one method or the other for similar types of hedges.

As a result, ISDA recommends that the FASB exclude the requirements in paragraphs 815-20-25-81 and 815-20-35-2B from its final hedging guidance.

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Interaction of Proposed Hedge Accounting Guidance and Leases

ASU 2016-02, *Leases (Topic 842)* deleted all of the guidance in ASC 815-20-55-198, which illustrated application of the cash flow hedge guidance to an operating lease, in its entirety. ISDA is unclear why this guidance was deleted, because it would seem that an operating lease that involves variable rate-payments would qualify as a cash flow hedge (presumably as such payments are indexed to inflation or LIBOR and thus would ostensibly be eligible for designation in a hedge of a contractually specified interest rate).

Also, pursuant to ASU 2016-02, substantially all leases will be capitalized on the balance sheet of lessees in fiscal periods that begin after December 15, 2018 (for public business entities). Given the new lease accounting standard, the Board should consider adding examples in any final hedge accounting guidance to illustrate application of the hedge accounting model to both operating and finance leases based on the new guidance in ASU 2016-2. As part of these examples, the Board should specify that liabilities related to both operating leases and finance leases that embody fixed lease payments over their contractual term are eligible for designation as a hedged item in fair value hedges of interest rate risk, as the subsequent measurement of the liability includes either an implicit or explicit interest cost element.

Consistent Use of Terminology

The exposure draft makes reference to both a “*contractually specified interest rate*” and a “*contractually specified interest rate index*.” In various places in the document (e.g., 815-20-25-15 references “...*interest rate*” whereas 815-20-55-62 references “...*interest rate index*”). To avoid any unintended consequences, we recommend the Board use consistent terminology throughout the guidance.

Hedging Embedded Call Options within Interest-Bearing Financial Instruments

Paragraph 815-25-55-29 of the Exposure Draft illustrates the application of the fair value hedging guidance to a non-bifurcated call option embedded within a 5-year fixed-rate debt instrument that is hedged via a mirror-image written option (a “call monetization strategy”). The example states the following regarding the designation of the hedged risk:

Because this Subtopic does not permit derivative instruments, including embedded derivatives whether or not they are required to be accounted for separately, to be separated into components, Entity F can only designate a hedge of the entire change in fair value of the embedded purchased call option.

ISDA is concerned that the retention of the guidance in paragraph 815-25-55-29 (which we believe is a function of the distinction that exists between hedged items described in paragraphs 815-20-25-12(2)(i) and 815-20-25-12(2)(iii)), would preclude application of the following proposed guidance to call option monetization strategies:

- Identifying the hedged item in a fair value hedge of interest rate risk as the benchmark rate component of a debt instrument’s full contractual coupon (815-25-35-13), and

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- Isolating the change in an embedded call option based solely on the benchmark interest rate (815-25-35-13A).

In light of the tentative decisions made by the FASB Board, ISDA believes that embedded, non-bifurcated call options identified as eligible hedged items in paragraph 815-20-25-12(2)(iii) also should be considered assets that are eligible for designating a benchmark rate as the hedged risk (per paragraph 815-20-25-12(f)(2)). The basis for our view is that if the embedded call option is not bifurcated and separately marked-to-market, it is part of an interest-bearing financial instrument that is sensitive to changes in a benchmark interest rate. When entities engage in call option monetization strategies, they are focused solely on hedging an exposure to benchmark swap rates—they are not seeking to hedge, and generally are not able to hedge, changes in their own credit risk. As such, continuing to require entities that engage call monetization strategies to designate the total changes in fair value of the embedded option is inconsistent with the FASB Board’s proposal to permit entities to identify the benchmark component of a debt instrument’s full contractual coupon and the ability to isolate changes in a callable debt instrument based solely on benchmark rates.

Potential Additional Targeted Improvements

In addition to our above comments requesting various clarifications, there are other aspects of hedge accounting for which we believe the FASB could provide additional targeted improvements either as part of this project or in a future project. Please see Appendix B.

Closing

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



Daniel Palomaki
Citigroup
Chair, N.A. Accounting Policy Committee

Responses to FASB's Questions for Respondents

Question 1: The Board decided it would allow an entity to designate the hedged risk as the variability in cash flows attributable to changes in a contractually specified component stated in the contract in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset. Do you agree with that decision? Please explain why or why not. If not, what specific alternatives should the Board consider? Please explain why those alternatives would be beneficial.

Our members agree with the decision to allow an entity to designate the variability in cash flows attributable to changes in a contractually specified component as the hedged risk in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset. We believe that this more closely aligns the results of hedge accounting with an entity's risk management activities.

However, we note the following:

- The example illustrating application of the proposed guidance on contractually specified nonfinancial components in paragraph 815-20-55-19 of the Exposure Draft implicitly prohibits designating a contractually specified price component as the hedged risk if there is an embedded, bifurcated derivative. However, the guidance does not specify the nature of the embedded derivative that is separately accounted for at fair value. ISDA is concerned that this example would preclude identification of a contractually specified nonfinancial price component as the hedged risk in cases where an embedded derivative in a nonfinancial contract that is separately accounted for at fair value is unrelated to the contractually specified nonfinancial price component (for example, foreign exchange risk). As such, ISDA recommends that the final guidance clarify that an entity is not prohibited from identifying a contractually specified price component within a contract if the contract contains a bifurcated embedded derivative that is unrelated to the identified nonfinancial risk.
- Paragraph 815-20-55-26B states *"if the contract references a different contractually specified component than the designated ABC soybean index...Entity A should discontinue hedge accounting...because the designated hedged risk is not present in the executed contract."* This proposed guidance suggests that similar, but not identical, nonfinancial risk components cannot be aggregated and identified as the hedged risk.

ISDA is unclear whether this restriction, which does not exist under the current cash flow hedge guidance, was intended by the Board. ISDA is concerned that if this was the Board's intention, it is overly restrictive as it would prohibit the continuation of cash flow hedge accounting where the contractual indexation of the probable, forecasted nonfinancial purchase or sale changes in a manner that results in the actual price of the hedged item being indexed to a similar (but not identical) exposure.

Relative to interest-rate-related cash flow hedges, such a restriction would create a higher standard for nonfinancial hedged items where the hedged risk is identified as a contractually specified

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component. ISDA is also concerned that this restriction could be applied by analogy to hedges of forecasted debt that will be indexed to a contractually specified interest rate, which would result in a change in current practice that we would not support. For example, there are common interest rate hedges executed by entities that borrow on a variable-rate basis that could be impacted by any analogy of the guidance proposed in paragraph 815-20-55-26B. In the U.S., variable-rate bank financing generally allows corporate borrowers to elect to have interest payments accrue at a variety of U.S. Dollar LIBOR tenors (e.g., 1 month, 3 month, 12 month). Entities that hedge such payments commonly forecast that they will consistently elect one of the indexes over the life of the hedge, but supplement their forecast with an effectiveness test demonstrating that their actual hedge (say, indexed to 1M LIBOR) would be highly effective in offsetting interest cash flows hypothetically indexed to 3M LIBOR (and other economically prudent rates). If an entity were to then change their forecast of the interest rate index to one that was deemed highly effective in their evaluation, they would update their hedge effectiveness testing and measurement of ineffectiveness to reflect such change. If the aforesaid restriction on nonfinancial components is applied by analogy to interest rate hedges this could preclude an entity from being able to change the designated interest rate index without cessation of hedge accounting (even if the originally forecasted and new indexes are highly correlated).

Question 2: The Board decided that it would retain the concept of benchmark interest rates for hedges of fixed-rate financial instruments and forecasted issuances or purchases of fixed-rate financial instruments, maintain the existing list of permissible benchmark rates, and add the SIFMA Municipal Swap Rate to the list.

- a. Should the Board retain the current concept of benchmark interest rates for fair value hedges of fixed-rate financial instruments and for cash flow hedges of forecasted issuances or purchases of fixed-rate financial instruments? Please explain why or why not.
- b. If the Board continues to maintain the current concept of benchmark interest rates, should the Board consider within the concept expectations that a rate will become widely used?
- c. If the Board continues to maintain a list of rates, are there any other rates that should be added to the list? Please explain why a particular rate meets the definition of a benchmark rate.
- d. Are there other alternatives to the current concept of benchmark interest rates the Board should consider (for example, a principles-based approach)? Please describe those alternatives.

- a. We agree with the Board's decision to retain the current concept of benchmark interest rates for fair value hedges of fixed-rate financial instruments and for cash flow hedges of forecasted issuances or purchases of fixed-rate financial instruments, with the modifications discussed in the response to Question 2.b. related to potential future benchmark rates.

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- b. Yes, market trends and financial markets regulatory activity indicate that new benchmark interest rates may arise and become widely used, similar to the overnight index swap rate that became such after the mandate for central clearing and collateralization of over-the-counter derivatives. The current Master Glossary definition of Benchmark Interest Rate includes a requirement that a benchmark rate must be widely recognized, quoted and used in an active financial market. ISDA believes that these conditions need not necessarily be met in order for a new rate to be added to the list of qualifying benchmark rates. It would be sufficient for there to be an *expectation* that a rate will become widely used and quoted in the future, based on facts and circumstances (e.g., a new rate that is endorsed by a government agency but is not yet widely used as an underlying basis for determining the interest rates of individual financial transactions).

Consistent with this, our members believe that the list of benchmark interest rates should not change frequently, but that the definition should incorporate an ability for the Board to react in a timely fashion when a newly-proposed rate is expected to become widely used, as follows (proposed edits are in bold, with additions underlined and deletions struck through):

***Benchmark Interest Rate** A rate that is or is expected to become widely recognized and quoted ~~rate~~ in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is or is expected to become widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions. In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate.*

- c. Our members believe that there are no other rates that should be added to the list of benchmark interest rates at this time, other than the Securities Industry and Financial Markets Association (SIFMA) index. We concur with the discussion in the Basis for Conclusions that SIFMA meets the definition of a benchmark interest rate. However, the Alternative Reference Rates Committee (ARRC)² has produced an Interim Report and Consultation outlining a strategy to create a widely-used alternative to U.S. dollar LIBOR. In its Interim Report, the ARRC noted that it had preliminarily narrowed its list to two rates that it considers to be the strongest potential alternatives, the Overnight Bank Funding Rate (OBFR) and some form of overnight Treasury General Collateral repurchase rate (Treasury GC repo rate).

We believe that either of these alternatives will deserve eventual consideration to be added as a permitted benchmark interest rate by FASB. The OBFR, produced by the Federal Reserve Bank

² The Federal Reserve convened the AARC, which is comprised of representatives from major over-the-counter derivatives market participants and their domestic and international supervisors and central banks, to identify a set of alternative reference interest rates that are more firmly based on transactions from a robust underlying market and that comply with emerging standards and to identify an adoption plan with means to facilitate the acceptance and use of these alternative reference rates.

of New York, reflects an active market based on daily borrowing transactions by a wide set of over 150 banks operating in the United States, similar in scope to the federal funds effective rate included on FASB's list of allowed benchmark interest rates. The OBFR is widely quoted by data service providers, and in addition the Risk Management Association and Securities Industry and Financial Markets Association have recently recommended that it be used as a benchmark for pricing and performance reporting purposes. An overnight Treasury GC repo rate would reflect a very active market, likely representing \$300 billion or more in daily borrowing transactions, and, as a secured rate, would reflect a risk-free rate available to high-quality financial institutions.

- d. We support the Board's proposal to retain a specific list of benchmark interest rates, subject to the comments in the preceding paragraphs.

Question 3: The Board decided that it would allow an entity to use either the full contractual coupon cash flows or the cash flows associated with the benchmark rate determined at hedge inception in calculating the change in the fair value of the hedged item attributable to interest rate risk, except when the current market yield of the financial instrument is below the benchmark rate at hedge inception. In that instance, the total contractual coupon cash flows would have to be used. Do you agree with this decision? Please explain why or why not.

ISDA believes the amendments improve existing GAAP and our members support this decision. This amendment will eliminate an IFRS to GAAP difference (under both IAS 39 and IFRS 9), and will provide flexibility to execute hedges that will more closely align hedge accounting with risk management activities, as it will allow entities to consider the market environment and the economics of the instruments being hedged at the time of hedge designation. However, ISDA believes certain clarifications to the Exposure Draft would be appropriate:

Late-term Benchmark Interest Rate Hedging

Paragraph 815-20-25-104(g)(2) of the Exposure Draft, which represents one of the conditions for applying the shortcut method, requires that the terms of either the interest rate swap or the hedged debt "*do not invalidate the assumption of perfect effectiveness*".

In practice, certain audit firms have invoked this condition to take exception with the designation of fair value hedges of fixed-rate debt that commence after the original issuance of the debt (i.e., "late-term" hedges) that are otherwise "plain-vanilla" hedging relationships. Consistent with this, entities may be challenged when designating late-term fair value hedges under the shortcut method.

While ISDA acknowledges that the Board's proposed amendments to the shortcut method criteria are limited to paragraph 815-20-25-104(e) regarding the maturity criterion, paragraph BC120 of the Exposure Draft highlights that the Board believes that fair value hedging can be applied to late-term hedges using the shortcut method. In light of the foregoing practice issue regarding the application of the shortcut

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method to late-term fair value hedges, we recommend that the clarification in BC120 addressing the propriety of such hedges be incorporated into paragraph 815-20-25-104.

Utilizing the Same Approach across Hedging Relationships

It is our understanding that there is no requirement for an entity to elect solely to measure the change in fair value of hedged items on the basis of the benchmark rate component of the contractual coupon cash flows determined at hedge inception or the full contractual coupon cash flows for similar hedges. Instead, an entity may select to apply either a benchmark coupon or total coupon approach for individual hedging relationships. For the avoidance of doubt, it would be helpful to explicitly clarify this in the final guidance, given that entities are required to use a consistent approach for similar hedges in certain other circumstances (see discussion on “Consistent Use of Hedge Effectiveness Methods” in the body of our letter).

We support the flexibility on this matter – particularly upon transition (as well as the prospective application) – as it will significantly reduce the cost of implementing the guidance. For example, certain existing hedging instruments may be more effective hedges from an accounting perspective when compared to the full contractual coupon of the hedged item (e.g., interest rate swaps with prepaid credit spreads) and, therefore it would be less costly to continue to use these hedges, as opposed to terminating them and executing new derivatives. In addition, certain entities may employ strategies that involve frequent (e.g., daily or weekly) de-designation and re-designation. In such cases, even if the entity wished to only incorporate the benchmark portion of the contractual coupon into long-haul for future hedges (i.e., effectively “grandfather in” existing relationships that use the full contractual coupon), it could be forced to update the mechanics of the existing relationships at the next point of re-designation, and such process would effectively create new hedging relationships.

Question 4: In regard to hedging forecasted transactions, paragraph 815-30-40-5, as amended, states that “a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity’s ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.” What is your policy on what constitutes a pattern? Are there certain instances or scenarios in which missed forecasts should not be incorporated into the consideration of this pattern?

Given the significant consequences that can result from a “*pattern of determining that hedged forecasted transactions are probable of not occurring*” (i.e., the potential loss of the ability to use hedge accounting in the future for similar forecasted transactions), entities generally take significant measures to minimize the probability that even a single forecasted transaction becomes probable of not occurring, and therefore may only develop policies regarding what constitutes a “pattern” when such guidance becomes required after a single “failure”.

ISDA believes there is opportunity for the Board to improve the guidance regarding the instances or scenarios in which missed forecasts should not be considered as contributing to a “pattern” of such

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activity. Specifically, the guidance in paragraph 815-30-40-4 could be amended as follows (changes are in bold with deletions are struck-through and additions are underlined):

The net derivative instrument gain or loss related to a discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter, except as indicated in the following sentence. ~~In rare cases, the~~ The existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the reporting entity may cause the forecasted transaction to be probable of occurring on a date that is beyond the additional two-month period of time, in which case the net derivative instrument gain or loss related to the discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income until it is reclassified into earnings pursuant to paragraphs 815-30-35-38 through 35-41.

ISDA believes the reference to “rare cases” has created an unreasonably high threshold that a forecasted hedged transaction that becomes probable of not occurring may only be excused (and not counted as being part of a pattern) when it is the result of truly exceptional circumstances that are beyond an entity’s control. It is clear that this requirement was intended as an anti-abuse provision to prevent entities from inappropriately recording changes in the fair value of derivatives to other comprehensive income, but it is not clear if the Board intended for “rare cases” to be interpreted as events or circumstances that are highly remote (in addition to being beyond an entity’s control). Experience has demonstrated that this has not been a practice issue and there is no economic incentive for entities to execute hedges of forecasted transactions that become probable of not occurring, as entities will not avoid the ultimate income statement recognition of amounts in other comprehensive income when this occurs.

To determine whether an entity should be “punished” and potentially lose the ability to apply cash flow hedge accounting, it should be sufficient to assess whether the change in the probability of a forecasted transaction was the result of events or circumstances that were outside the control or influence of the entity, and it should not be necessary for those events or circumstances to be of the magnitude of a global financial crisis (for example) in order to not to be considered as part of a pattern.

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Question 5: Are there hedging relationships that would be eligible to meet the requirements in the proposed amendments and IFRS 9, but the hedge results would be recognized and presented differently? If so, please describe the transaction and why it would be recognized and presented differently in accordance with IFRS 9.

ISDA notes that the following aspects of hedge accounting are addressed in the requirements in the proposed amendments and in IFRS 9, but the would be recognized and presented differently:

- Differences related to forward points and option time value: Under IFRS 9, a separate AOCI account exists for forward points and option time value, and the hedging entity is required to apply a rational amortization methodology to reverse those amounts. Under current GAAP and the proposed amendments, amortizing forward points and option time value in a systematic and rational manner has been precluded. Our members believe the IFRS 9 approach would be consistent with the presentation approach under the cost of hedging model for the effective and the ineffective portions of the change in the fair value of the hedging instrument;
- Presentation of excluded components in a separate line item: IFRS 9 does not require presentation of an excluded component in the same line item as the earnings effect of the hedged item. ISDA members believe the IFRS 9 approach better serves users of financial statements due to user desire to retain the information content inherent in certain income statement line items and their related metrics, such as interest income, interest expense and net interest margin. As users expressed in the feedback to Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*, the information contained in certain income statement line items is critical to their analysis and should not be distorted by other information that is not as essential to their cash flow predictions.
- Cross currency basis risk: IFRS 9 allows the full changes in the foreign currency basis spread to be recognized in other comprehensive income and accumulated in a separate component of equity. The initial value of the foreign currency basis spread is then amortized to profit or loss over the related hedge period. Our members believe that US GAAP should apply a similar approach to cross-currency basis risk, which occurs in common hedging relationships such as a fair value hedge of foreign currency risk using foreign-fixed/USD floating cross currency swaps. While the cash flows of the hedged item may be entirely offset by the terms of a swap and the cross currency basis is locked in for the term of the swap (similar to forward points), the cross currency basis between the interest rate curves relative to the two currencies can be extremely volatile, and possibly material to the overall financial statement results. If the hedge remains designated until the maturity of the hedging derivative, which is often the case for hedges of long term debt, these fair value changes will reverse over time, with the cost of cross currency basis equal to that at origination of the cross currency swap.

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Question 6: Do you agree with the following Board decisions on presentation? Please explain why or why not. If not, what other alternatives should the Board consider?

- a. For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would modify current GAAP by requiring the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is presented.
- b. For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would retain current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be recorded currently in earnings. For qualifying fair value and cash flow hedges, the proposed amendments would modify current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be presented in the same income statement line in which the earnings effect of the hedged item is (or will be) presented. For qualifying net investment hedges, there will be no prescribed presentation requirements for changes in the fair value of the hedging instrument excluded from the assessment of effectiveness.
- c. For cash flow hedges in which the hedged forecasted transaction is probable of not occurring, the proposed amendments would retain current GAAP by requiring amounts recorded in accumulated other comprehensive income to be reclassified to earnings immediately. However, the proposed amendments would require presentation of reclassified amounts in the same income statement line item in which the earnings effect of the hedged item would have been presented had the hedged forecasted transaction occurred.

- a. We agree with the proposed requirement that for qualifying fair value, cash flow, and net investment hedges, the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness should be presented in the same income statement line item in which the earnings effect of the hedged item is presented.
- b. ISDA agrees that the current US GAAP guidance on the recognition and presentation of changes in the fair value of hedging instruments is sufficient, including the requirement that changes in the fair value of the hedging instrument excluded from the assessment of effectiveness be recorded currently in earnings.

However, ISDA disagrees with the proposed amendment to require changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is (or will be) presented. ISDA believes the current guidance that has developed through SEC speeches and industry practice, coupled with incremental disclosure of the income statement lines used by an entity to account for hedging derivatives would be sufficient for the presentation of changes in the fair value of a hedging instrument that are excluded from the assessment of effectiveness.

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In the Basis for Conclusions of the Exposure Draft, the Board noted that they chose the new recognition and presentation approach based on the view that if an entity enters into a hedging instrument, the entire change in the fair value of the hedging instrument (that is, the effective and the ineffective portions and amounts excluded from the assessment of effectiveness) should be considered a cost of hedging (i.e. cost of hedging model). The Board further noted that the proposed measurement methodologies for fair value hedges of interest rate risk and the ability to designate the variability in cash flows attributable to changes in a contractually specified component as the hedged risk in a cash flow hedge would reduce or potentially eliminate the earnings mismatches (that is, “ineffectiveness”) that exist under current GAAP for these hedging strategies.

While we agree that the Exposure Draft will allow entities to design more specific hedges that may minimize what is today considered ineffectiveness (e.g., via partial-term and/or benchmark-rate component cash flows for fair value hedges and contractually specified components for cash flow hedges), the amendments will not eliminate the net volatility that arises from sources other than the hedged risk. As a result, the mandatory presentation requirements may distort results and may not accurately reflect an entity’s risk management activities.

For example, in a fair value hedge of interest rate risk for a recognized asset or liability, where the significant terms of the hedged item and hedging derivative may exactly match (e.g., notional, tenor, settlement dates, fixed interest rate, etc.), the fixed cash flows of the hedged item are usually discounted using the designated benchmark interest rate, while the change in the value of the hedging derivative will be based on the effects of discounting cash flows using an overnight rate (such as Fed Funds Effective) if the derivative is collateralized, or alternatively will include adjustments to reflect the creditworthiness of the counterparties if it is not collateralized (i.e., CVA/DVA). This will result in periodic differences between the change in value of the hedged item and the hedging derivative, which should be captured in earnings in the period in which they occur, but should not necessarily create volatility in net interest margin (for example) in a hedge of interest rate risk.

In the above example, the valuation differences primarily relate to the riskiness of the future interest settlements and not to the current period interest accruals, and therefore should not be seen as a “cost of hedging.” In other words, the differences arise because the valuation of the hedging derivative reflects a hypothetical transfer of the instrument (i.e., an exit price), which will not be realized if the derivative continues to be held as a hedging instrument, and therefore should not be presented on the same line as the change in the value of the hedged item.

Given the sensitivity and emphasis placed on individual income statement lines in different industry sectors, ISDA believes it would be more appropriate to allow entities to make an accounting policy election to present current period interest accruals for the hedged item and the hedging derivative in net interest margin, and the change in the value of the future interest settlements of the hedged item and hedging derivative in another (but identical) income or

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expense line item that is identified through footnote disclosure. The availability of such an accounting policy election would be consistent with the ability for entities to elect to assess hedge effectiveness on a basis that either includes or excludes the current period interest accruals of the hedged item and hedging derivative.

- c. For cash flow hedges in which the hedged forecasted transaction is probable of not occurring, we question whether presentation of reclassified amounts in the same income statement line item in which the earnings effect of the hedged item would have been presented had the hedged forecasted transaction occurred will provide decision-useful information, given the current requirement to disclose the amounts that were reclassified from OCI because hedged transaction was deemed to be probable of no longer occurring.

Question 7: Do you agree with the proposed disclosure amendments in (a), (b), and (c) below? Please explain why or why not.

- a. Cumulative basis adjustments related to fair value hedges
- b. Quantitative hedge accounting goals, if any, that an entity sets when developing its hedge accounting objectives and strategies and whether it met those goals
- c. Revised tabular disclosure for fair value and cash flow hedges that would focus on the effect of hedge accounting on income statement line items.

ISDA believes that the proposed disclosure amendments in a. and c. above provide decision-useful information and that this information is readily available for most entities.

However, some of our members believe that the proposed disclosure amendments in b. above will be difficult to provide and may not be comparable, especially for complex global entities that have multiple types of hedges and varying objectives and strategies. This is not only because hedging strategies and goals may dynamically change based on many factors, but also because similar entities may not be exposed to similar risks or to similar risks to the same degree. Further, an entity might consider the information regarding quantitative hedge accounting goals and whether it met those goals to be proprietary. To the extent that hedging strategies are material to a reporting entity, this information more appropriately belongs in the entity's MD&A. Because of these reasons, ISDA recommends that the standard should focus on the qualitative objectives, rather than the quantitative hedge accounting goals.

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Question 8: Unless the hedging relationship meets one of the exceptions that assumes perfect offset at hedge inception, an entity would be required to perform an initial quantitative test of hedge effectiveness and would be allowed to perform subsequent hedge effectiveness assessments qualitatively unless facts and circumstances change. Do you agree with this proposed change? Please explain why or why not.

We agree with the proposed change that allows an entity to perform subsequent hedge effectiveness assessments qualitatively unless facts and circumstances change. Our members believe that these changes would ease the administrative burden of applying hedge accounting and potentially reduce costs as entities would no longer be required to perform ongoing quantitative hedge effectiveness assessments if facts and circumstances did not change. Further, we support the optionality of the subsequent qualitative assessments as we note that for certain entities with automated processes, performing subsequent quantitative assessments would continue to be more cost effective than subsequent qualitative assessments.

However, when considering the proposed requirements in conjunction with the critical terms match method, ISDA believes there are some counter-intuitive answers. Consider two scenarios:

1. A hedging relationship does not utilize the critical terms match method and is 95% effective at inception. The proposed requirements would allow for subsequent qualitative assessments and only require quantitative assessments if facts and circumstances change
2. A hedging relationship utilizes the critical terms match method at inception and does not perform a quantitative test. The proposed requirements would require quantitative assessments if there is any change

We note that the FASB acknowledges this fact in the Basis for Conclusions and concludes that this is reasonable for a variety of reasons. Our members continue to believe that there should not be a larger administrative burden for the critical terms match method.

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Question 9: The Board decided that an entity may elect at hedge inception to perform subsequent assessment of effectiveness qualitatively. However, certain changes in the facts and circumstances associated with the hedging relationship in subsequent periods may require a quantitative assessment of effectiveness to be performed. Once an entity determines that a quantitative assessment of effectiveness is required, the entity would be prohibited to return to qualitative testing in periods after this determination is made. Can situations arise in which an entity no longer may assert qualitatively that the hedging relationship continues to be highly effective but when tested quantitatively would be highly effective? If so, please describe those circumstances. Should an entity be allowed to return to qualitative testing after such a significant change in facts and circumstances precluded it in a prior period? If so, please discuss the factors that an entity should consider to justify a reasonable expectation that the hedge will once again be highly effective on a qualitative basis.

ISDA believes that there could be situations that arise in which an entity no longer may assert qualitatively that the hedging relationship continues to be highly effective but when testing quantitatively would be highly effective.

Further, consistent with our view expressed in our response to question #8 relating to hedging relationships that start under the critical-terms-match method and revert subsequently to quantitative assessments, ISDA believes an entity should be allowed to revert back to a qualitative method after a significant change in facts and circumstances requires a hedge to be evaluated quantitatively (assuming certain factors are met). For example, if the quantitative assessment performed demonstrates a highly effective offset and facts and circumstances have not changed to an extent that an entity can no longer assert qualitatively that the hedging relationship continues to be highly effective, then our members believe that an entity should be able to return to qualitative testing. These factors are consistent with the factors laid out in paragraph BC79 of the Basis for Conclusions for hedging relationships in which the initial quantitative assessment at inception indicates a highly effective relationship.

Question 10: Do you agree with the proposed amendment that would allow an entity to perform the initial quantitative testing portion of hedge documentation at any time between hedge inception and the quarterly effectiveness testing date using data applicable as of the date of hedge inception? Please explain why or why not.

ISDA agrees with the proposed amendment that would allow an entity to perform the initial quantitative testing portion of hedge documentation at any time between hedge inception and the quarterly effectiveness testing date using data applicable as of the date of hedge inception.

We believe the intent of the current requirements under ASC 815 is to prevent entities from retroactively designating a hedging relationship to achieve a desired accounting result. As the proposed amendment still requires all other hedge documentation to be in place at hedge inception, we do not believe this

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amendment undermines the FASB's intent. Further, this change will provide relief to the requirements around initial quantitative testing that many entities find onerous.

Question 11: The proposed amendments related to the timing of the preparation of hedge documentation and subsequent qualitative testing apply to both public entities and private companies. Are there valid reasons why the content of or the timing of the preparation of hedge documentation should be different for public entities and private companies? If so, please describe the specific types of transactions for which different treatment should be considered.

In our opinion, the proposed amendments should be consistent for both public and private entities. We do not believe that any variation would be required to meet the needs of private entities.

Question 12: Should the effective date be the same for both public business entities and entities other than public business entities?

Implementation of this guidance should be straightforward for both public business entities and entities other than public business entities that elect to apply hedge accounting today. Therefore, we believe the effective date should be the same for both public business entities and entities other than public business entities.

Question 13: How much time is needed to implement the proposed amendments? Should entities other than public business entities be provided more time? If so, how much more time?

The changes to the hedging model, as proposed, are not substantial but would require enhancements to policies, procedures, and systems. In order to implement the requirements, particularly for entities other than public business entities, ISDA believes the effective date should be one year from the release of the final guidance. However, regardless of the effective date, we believe that early adoption should be permitted immediately for entities to take advantage of the targeted improvements to the hedging model.

Question 14: Do you agree with the proposed transition method and disclosures in paragraph 815-20-65-3? Do you agree with the Board's decision not to allow a retrospective transition approach? Please explain why or why not.

ISDA agrees the proposed transition method and disclosures in paragraph 815-20-65-3. We also agree with the Board's decision not to allow the retrospective transition approach because we believe the costs of this approach outweigh the benefits.

In addition, as provided in paragraph 815-20-65-3(g), our members appreciate the elections provided by the Board to modify the documentation for certain existing hedging relationships to specify (a) that

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subsequent prospective and retrospective effectiveness assessments will be performed qualitatively without dedesignating the hedging relationship, and (b) the quantitative “long-haul” method that would be used to perform assessments of effectiveness if an entity determines at a later date that use of the shortcut method was not or is no longer appropriate.

However, we request the Board clarify whether modification of each individual hedging relationship’s documentation is necessary. We believe it would be inefficient to modify the documentation related to individual hedging relationships. Rather, we believe that the final guidance should clearly state that entities may document how they will prospectively apply the guidance for groups of similar hedging relationships (e.g., using a “cover memo” to document that certain specific assets designated as part of similar benchmark interest rate hedging relationships will cease to be assessed for effectiveness using a quarterly quantitative rolling regression (for example), because the entity will prospectively perform qualitative assessments in accordance with 815-20-25-117A without dedesignating the hedging relationships).

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Appendix A

Example Alternative Reclassification of Other Comprehensive Income for an Off-market Swap

Consider the following example that illustrates the approach based on the guidance in the Exposure Draft. Assume that on February 6, 20X4, an entity designates a pay-fixed swap contract that was originated on March 15, 20X2 (and has an existing non-zero fair value) as a cash flow hedge of forecasted interest payments to be made through March 15, 20X7.

	Actual off-market pay fixed swap	Hypothetically perfect pay fixed swap
Origin date	3/15/20X2	2/6/20X4
Maturity date	3/15/20X7	3/15/20X7
Notional amount	\$1,000,000	\$1,000,000
Fixed leg terms (pay rate)	5% (2.5% semiannual)	3% (1.5% semiannual)
Floating leg terms (receive rate)	LIBOR	LIBOR

In this example, the entity seeks to begin a new hedging relationship on 2/6/20X4 with an existing pay-fixed swap. However, the zero coupon interest rate curve has shifted downward since the swap was executed, and now a new swap with the same variable cash flows and the same maturity date of 3/15/20X7 would feature a pay fixed rate of 3%, rather than 5%. Accordingly, the swap has a negative fair value on 2/6/20X4, the date of redesignation.

Effectively, the entity could evaluate the swap as economically equivalent to (1) a zero fair value interest rate swap maturing 3/15/20X7 with fixed semi-annual cash flows of \$15,000 (1.5% of \$1,000,000) and floating cash flows equal to LIBOR x \$1,000,000, plus (2) seven discrete payments of \$10,000 (the quantified difference between the fixed legs or 2.5%-1.5% x \$1,000,000) each due semi-annually.

Because component (1) is the hypothetically perfect component of the actual swap, any ineffectiveness will be related to the off-market element component (2). The change in fair value related to the off-market portion of using the swap in a new hedge can be encapsulated as “the changes in fair value associated with a series of seven \$10,000 payables due every six months beginning on 3/15/X4.”

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Appendix B

Potential Additional Targeted Improvements

Interaction of Counterparty Credit Risk and Fair Value Hedges of Benchmark Interest Rates

Under current ASC Topic 815 guidance, for any fair value hedge of benchmark interest rates that does not qualify for the shortcut method, an entity must measure and recognize [in earnings] any difference between the change in the fair value of the interest rate swap and the change in the fair value of the hedged item due solely to changes in the hedged risk. However, because derivatives are measured at fair value through earnings under ASC Topic 820, changes in the fair value of the hedging instrument include changes in counterparty credit risk or own credit risk (collectively, credit risk), to the extent the derivative is not subject to collateral. However, changes in the fair value of the hedged item only reflect changes in the hedged risk (i.e., interest rates). This valuation difference can have an impact on the assessment of hedge effectiveness, although it does not relate to the risk being hedged or necessarily indicate a change in the expected cash flows of the hedging instrument.

In light of the FASB Board's tentative decision to simplify the application of the long-haul method to fair value hedges of interest rate risk (which ISDA supports), we recommend that the FASB further simplify the effectiveness assessment for these hedge relationships by allowing entities to exclude from their assessment of hedge effectiveness changes in credit risk of the hedging instrument. Allowing such an election would be consistent with FASB's objective of more closely aligning hedge accounting with risk management activities. It would also be consistent with the FASB's decision for fair value hedges of interest rate risk to allow entities to elect to assess hedge effectiveness and record hedge results in earnings based solely on the benchmark interest rate component of contractual cash flows (i.e., to exclude from the hedge effectiveness assessment and earnings the effects of interest rate risk on a financial instrument's yield in excess of the benchmark interest rate). In addition, this would be consistent with the FASB's proposed simplification to hedging callable debt, which allows the entity to focus on changes thereto only as they relate to the risk being hedged (e.g., the benchmark interest rate). Further, the existing framework for measuring effectiveness in cash flow hedges of benchmark interest rates as contemplated in ASC 815-30-35 (formerly DIG Issue G7) generally provides a model where credit risk is not a source of ineffectiveness (for example, because it is mirrored in the terms of the hypothetical), noting that the approaches provided in that guidance – particularly the hypothetical derivative method – are also used in practice as part of the assessment process. To that end and solely in the context of assessing the effectiveness of a fair value hedge of the benchmark interest rate, it may be reasonable to incorporate a similar concept in the fair value hedging model.

For the avoidance of doubt, we would expect entities to continue to recognize the total changes in fair value of a hedging instrument in earnings (including changes in credit risk), and that entities would continue to be required to consider the likelihood of a counterparty's compliance with the contractual terms of the hedging instrument each period. This recommended revision to the Exposure Draft would only relate to the assessment of hedge effectiveness, consistent with the ability to include or exclude the time value of a hedging instrument from the assessment of effectiveness of certain hedge relationships.

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Hedging a Business Combination with the Purchase Price Denominated in a Foreign Currency

Entities often acquire foreign businesses, whether as part of bolt-on transactions or strategic/transformational transactions, where the purchase price (cash consideration) is denominated in a foreign currency. U.S. GAAP prohibits application of hedge accounting to transactions accounted for as business combinations under ASC Topic 805. However, entities consummating foreign acquisitions of businesses for which the acquisition currency differs from the acquirer's functional currency commonly economically hedge at least some portion of the overall purchase price, with such economic hedges marked-to-market through earnings.

The foreign currency risk associated with a probable, forecasted business combination (and firm commitment) creates an economic exposure. Specifically, the cash consideration transferred to the seller and consequently the value at which identifiable assets and liabilities (and if applicable, goodwill) are recognized by the acquirer. This economic exposure affects earnings through amortization expense, impairment charges and gains/losses on any subsequent transfers of the acquired assets or liabilities.

ISDA recommends that the FASB allow this economic risk to be an eligible hedged risk in a cash flow hedge or fair value hedge of foreign currency risk. Allowing foreign currency risk associated with probable foreign business combinations to be designated as a hedged item would yield a converged outcome with IFRS, as IAS 39 and IFRS 9 permit a highly probable, forecasted foreign transaction to acquire a business (and firm commitment) to be designated in either a cash flow hedge or a fair value hedge.

Hedging Foreign Currency Denominated Debt Issuances

Entities commonly issue foreign-currency denominated debt in foreign capital markets for both investor diversification purposes as well as natural hedging purposes (e.g., to match against foreign currency operating cash flows). These foreign debt issuances expose an entity to foreign currency risk from the date the transaction is probable to the date the debt is issued. Notwithstanding this economic risk, there is an implicit prohibition on this type of hedge because the requirement in ASC 815-20-25-15(c)(2) is not met. This implicit prohibition was raised in deliberations by the FASB in Derivatives Implementation Group Issue No. H17, which was never finalized. Since this risk is economic and affects earnings, as entities will receive a greater or lesser functional-currency equivalent amount of proceeds from foreign currency debt issued, which will subsequently give rise to greater or lesser foreign currency remeasurement gains/losses under ASC Topic 830, as well as interest expense, ISDA recommends that the FASB allow this economic risk to be eligible as a hedged risk in a cash flow hedge of foreign currency risk. This would allow entities that plan to issue foreign currency denominated debt to prudently hedge their economic exposure to foreign currency risk through the issuance date to avoid uneconomic volatility in earnings that results from the current accounting treatment for such hedges. We reference the illustrative example in the proposed DIG Issue H17.

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