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

Re: File Reference: Proposed Issue E23

Dear Mr. Golden:

The International Swaps and Derivatives Association ("ISDA") is pleased to provide the following comments with respect to the Financial Accounting Standards Board's (the "FASB") proposed FASB Statement No. 133 Implementation Issue E23, "Issues Involving the Application of the *Shortcut Method* under Paragraph 68" (the "DIG Issue"). 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.

The provision of the proposed DIG Issue that prohibits an entity to apply the shortcut method to a fair value hedge designated after the initial recognition of a financial instrument ("late" hedges) is unequivocally an amendment to SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"), and it is our view that an amendment of this magnitude should not be made via the issuance of a DIG Issue. ISDA strongly disagrees with the FASB's basis for proposing this specific provision— that paragraph 68(e) of SFAS 133 implies that the par value of a hedged item designated in a fair value hedge must equal its principal amount at the inception of the hedging relationship— as there is evidence in SFAS 133 and its authoritative interpretations that indicates that no such implication was originally intended.

Based on ISDA member discussions with corporate clients who use the shortcut method, the elimination of the ability to use the shortcut method after initial recognition will have a significant negative impact, and will also eliminate the ability of many corporations to utilize hedge accounting at all. Therefore, we strongly object to FASB including the provision regarding “late” hedges in the final DIG Issue.

Should the FASB decide to ratify the proposed DIG Issue as currently drafted, we believe that the effective date for adoption of the “late” hedge provision should be delayed until at least January 1, 2009, consistent with the implementation period required for an amendment of this magnitude. Otherwise, ISDA member conversations with corporate clients indicate that many preparers will be required to either abandon prudent risk management strategies or cope with income statement volatility that does not reflect the underlying economics for an extended period as they build the infrastructure necessary to apply the long haul method.

ISDA generally supports the concepts included within the remaining provisions of the proposed DIG Issue; however, we request that you consider our comments enumerated in the remainder of this letter. We hope you find ISDA’s comments informative and beneficial. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned.

Sincerely,

Laurin Smith

Laurin Smith
J.P. Morgan Chase & Co.
Chair, North America Accounting Policy Committee
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1. **<u>Paragraph 68(e)(6) – "Late" Hedges</u>**

The Need for the Shortcut Method for "Late" Hedges

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 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 replicated 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 securities that have significant credit spreads may not qualify for hedge accounting under the long haul method, this amendment may preclude the use of hedge accounting for those entities entirely. In addition, under the amendment the shortcut method would generally be precluded for secondary market purchases of fixed rate available-for-sale securities, as the par value of these instruments rarely equals the fair value when purchased. ISDA strongly supports the retention of the shortcut method in general, and specifically for hedges that begin after initial recognition of the financial instrument.

The Basis for the Elimination of the Shortcut Method for "Late" Hedges

ISDA strongly agrees with the three dissenting Board members who believe that SFAS 133 expressly permits an entity to use the shortcut method of assessing hedge effectiveness for hedging relationships using an interest rate swap that was transacted on a date other than the issuance date of the hedged item based on the footnotes to paragraphs 115 and 134 of SFAS 133. Those footnotes state that the trade date of the swap and the borrowing date of the debt "need not match for the assumption of no ineffectiveness to be appropriate." ISDA believes that the FASB also endorsed "late" hedges in Derivatives Implementation ("DIG") Issue J9, "Use of the Shortcut Method in the Transition Adjustment and Upon Initial Adoption", which explains how an entity could have designated an existing hedged item not previously designated in a hedging relationship in a new shortcut eligible hedging relationship upon the entity's adoption of SFAS 133 as long as the swap had a fair value of zero on that date.

ISDA firmly disagrees with the majority view of the FASB that the proposed guidance regarding "late" hedges is consistent with the conclusions reached in DIG Issue E15, "Continuing the Shortcut Method after a Purchase Business Combination". DIG Issue E15 concludes that the shortcut method cannot be applied because the business combination resulted in the designation of a new hedging relationship and, under that new relationship, the interest rate swap did not have a fair value of zero. DIG Issue E15 did not conclude that the hedging relationship is not eligible for the shortcut method because the fair value of the hedged item is not equal to its principal amount. We fail to see any relationship between the conclusions reached in DIG Issue E15 and in the proposed DIG Issue, based on the words contained in DIG Issue E15 and based on the consensus interpretation and application since its issuance.

ISDA strongly supports the alternative views put forth by the minority Board members in the proposed DIG Issue which state, "…changes in the fair value of a debt instrument prior to the hedge transaction do not distort the effectiveness of the hedging relationship going forward, provided that the terms of the swap match the remaining term of the debt. In that case, it is still reasonable to assume that changes in fair value of the swap will be highly effective in offsetting subsequent changes in the fair value of the debt attributable solely to subsequent changes in the benchmark interest rate. Other accounting standards would govern the recognition in earnings of any premium or discount on the hedged item prior to the inception of the hedge. That element does not represent ineffectiveness in the current hedging transaction." As stated above, we also assert that the shortcut method is the best financial reporting representation of the use of interest rate swaps to "swap the coupon" of a fixed-rate financial instrument to a floating rate.

We understand that the proposed guidance for "late" hedges arose from the FASB's discussion of the application of the shortcut method to zero-coupon financial instruments ("zeros"), and the potential similarities in the original issue or purchase discounts on zeros and "late" hedges. However, as noted by the FASB in the proposed DIG Issue, the swaps used as hedging instruments in the two types of hedge relationships have very different terms and economics. We believe that the financial reporting improvements perceived by the FASB in eliminating the application of the shortcut method for zeros will be vastly outweighed by the deterioration in financial reporting as a result of the elimination of "late" hedges, and that the scope of the FASB's desired improvements for zeros can be adequately scoped without impairing the financial reporting for "late" hedges.

In summary, ISDA strongly believes that the elimination of "late" hedging introduces a new principle that was never intended by the FASB upon issuance of SFAS 133 and SFAS 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and represents a deterioration in financial reporting. We do not believe it is appropriate to consider an amendment of this magnitude outside of a comprehensive project to address the costs and obstacles to achieving hedge accounting under the long haul method, which are discussed below.

Cost/Benefit of Proposed DIG Issue

Many of ISDA's large financial institution members have eliminated the use of the shortcut method due to the continued reinterpretation of the paragraph 68 requirements, and have adopted the long haul method for those hedge relationships. Such implementations have proven to be highly complex, due in part to the significant diversity in auditor and regulator interpretation regarding how the long haul method should be applied. For example, the following items are often the subject of debate among auditors and preparers:

- How an entity should amortize the basis adjustments made to the hedged item over the life of the hedging relationship,
- Which portion of the beginning of period yield curve should be used to discount the end of period cash flows when applying the guidance set forth in paragraph 120C of SFAS 133, and
- How the credit spread of a debt instrument should be incorporated into the discount curve used to determine the fair value of the hedged item if only changes in a benchmark interest rate are being hedged (e.g., impact of credit spread changes on an embedded call option).

For details on these and other long haul method complexities, we refer to our presentations given to certain Board members and Staff dated April and June 2006.

Once the above technical issues are agreed with an entity's auditor, the entity will still need to expend a significant amount of time, resources and costs to implement the long haul method, including but not limited to implementing systems, adding qualified professionals to an entity's accounting and treasury staff, designing and documenting hedge strategies and assumptions, consulting with advisers and accountants, and implementing additional internal controls. The experiences of large financial institutions who have abandoned the use of the shortcut method have indicated that transitioning to the long haul method is a complicated and time consuming process, even for firms that have in-house valuation systems and quantitative expertise. Many corporations have been using the shortcut or critical terms match methodologies for a majority of their hedges, which methodologies generally did not require those firms to have the systems or quantitative resources that most financial institutions have. Accordingly, we believe that requiring most corporations to implement the long haul method for fair value hedges will fail the most basic cost/benefit analysis when compared to a properly implemented shortcut hedge relationship.

As discussed above "late" hedges are commonly executed by many enterprises who are simply attempting to "swap the coupon" on their fixed rate obligations or entities attempting to modify the duration of their available-for-sale securities or liabilities (and not hedge changes in the fair value of these instruments). It seems counterintuitive to require preparers to prove a fair value hedging relationship is highly effective when a qualitative review of the terms of the hedge item and hedging instrument would enable a preparer or an auditor to know whether the hedge is successful in transforming a fixed rate exposure into a floating rate exposure.

For these reasons, we request the FASB to consider the cost/benefit of requiring entities to implement the long haul method for "late" hedges, as we believe the result is a poorer representation of the economics of a "swap to floating" hedge strategy and which requires great initial and ongoing investment. Given that FASB's broad project on hedge accounting may result in additional changes to the long haul method of accounting for "late" hedges, we further believe the cost of the proposed, "temporary" change outweighs any benefits perceived by the FASB.

Transition / Effective Date

Should FASB decide to ratify the proposed DIG Issue as currently drafted, we believe the effective date for adoption of the "late" hedge provision should be delayed until at least January 1, 2009, consistent with the implementation period required for an amendment of this magnitude. ISDA members' conversations with corporate clients indicate that many preparers will be required to either abandon prudent risk management strategies or cope with income statement volatility that does not reflect the underlying net risk exposure or their risk management practices as they build the infrastructure necessary to qualify for the long haul method. Also, as with all proposed guidance, it is not practical for corporations currently using the shortcut method for "late" fair value hedges to expend resources to implement the systems, processes, and controls required to properly adopt the long haul method until the FASB issues the final guidance. ISDA members' experiences in implementing the long haul method for their own organizations are that the process generally requires up to one year to fully implement.

2. <u>Paragraph 68(1) – Date of Designation</u>

Paragraph 68(1) of the proposed DIG issue provides that, "the shortcut method may be applied to a qualifying fair value hedge when the relationship is designated on the trade date of both the swap and the hedged item even though the hedged item is not recognized for accounting purposes until the transaction settles…" We understand that the FASB's intent is to assert that it is equally permissible to designate an interest rate swap in a shortcut hedge (fair value or cash flow) either on the trade date (e.g., the pricing date of interest bearing financial instrument) or the settlement date (e.g., date on which the hedged item is initially recognized) of the hedged item. However, as the proposed DIG Issue is currently drafted, we believe that a preparer or auditor could conclude that an entity is precluded from designating a shortcut eligible fair value or cash flow hedge on the trade date because the instrument is not yet recognized (a current requirement of paragraph 68), or is precluded from designating an otherwise shortcut eligible fair value hedge on the settlement date of the financial instrument because its fair value may not equal its principal amount on that date.

Accordingly, we recommend that FASB clarify that an entity may to apply the shortcut method to a qualifying fair value hedge either on the trade date or settlement date of the financial instrument designated as the hedged item, as long as the period of time between these two dates is within established conventions for that marketplace. We also encourage the FASB explicitly state either in the body of the DIG Issue or the basis for conclusions that it is equally acceptable to designate a shortcut hedge either on the trade date or settlement date of the financial instrument representing the hedged item.

3. <u>Paragraph 68(e)(4) – Terms of Interest Rate Swap and Hedged Item</u>

ISDA recommends the following modification to paragraph 68(e)(4) of the proposed DIG Issue relating to the terms of an interest rate swap and the interest bearing financial instrument designated in a shortcut hedge (inserted text is <u>underlined</u>).

4. Paragraph 68(e) is met if the <u>critical</u> terms of the interest rate swap and the interest-bearing financial instrument both are typical for those instruments and do not invalidate the assumption of no ineffectiveness.

Furthermore, ISDA believes that the FASB should provide guidance regarding what constitutes a critical term and provide specific examples of what the critical terms of both an interest rate swap and an interest bearing financial instrument are.

ISDA believes that terms that do not affect the fair value of either the interest rate swap or the interest bearing asset or liability are not critical (for example, the denomination in which an interest bearing asset or liability can be redeemed) and therefore recommends that FASB explicitly provide that these noncritical terms need not be considered when determining whether the provisions of paragraph 68(e) have been met. Our recommendation is proposed in light of a registrant's recent restatement of its financial statements resulting from an unusual interpretation by the PCAOB of the criteria that must be met in order for a hedging relationship to qualify for the shortcut method.

4. <u>Paragraph 68</u>

ISDA recommends the following modification to paragraph 68 of the proposed DIG Issue relating to the date on which a shortcut hedge can be designated (inserted text is <u>underlined</u> and deleted text is ~~struck~~).

> Paragraph 68:
>
> An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest-bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries. If all of the applicable conditions in the following subparagraphs are met, an entity may assume no ineffectiveness in a hedging relationship of interest rate risk involving a recognized interest bearing asset or liability (or a ~~firm~~ commitment <u>probable of occurring</u> arising on the trade date to issue or purchase an interest-bearing asset or liability provided that the trade date of the asset or liability differs from its settlement date due to generally established conventions in the marketplace in which the transaction is executed) and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 68(d) below).

Given the proposed normal settlement provisions of paragraph 68, one could argue the recognition of the debt must be probable in order for a hedging relationship to qualify for the shortcut method. However, there are a significant number of arrangements under which debt instruments designated in shortcut hedges may not technically meet the definition of a firm commitment during the period of time between trade date and settlement date as defined in

Appendix F of SFAS 133, even though in practice it is almost certain that, after pricing of the financial instrument, settlement of the instrument will occur, even in significantly disrupted market conditions. Thus, we believe that some in practice may literally apply the phrase "firm commitment" to shortcut eligible hedging relationships— thus potentially resulting in the unintended consequence of many hedging relationships failing to qualify for the shortcut method.

We also recommend that FASB clarify in the Basis for Conclusions that its intentions regarding this provision are to specifically address whether a shortcut hedge can be designated when there is a difference between trade date and settlement date of an interest bearing financial instrument.

5. <u>Paragraph 68(a)</u>

ISDA recommends that FASB clarify that it is permissible for an entity to apply the shortcut method when it is only hedging a portion of the cash flow arising from, or the fair value of, an interest bearing financial instrument, because it is not clear this is permissible as a result of the changes to paragraph 68(a). Accordingly, we recommend the following modification to paragraph 2 of the DIG Issue and paragraph 68(a) (inserted text is <u>underlined</u> and deleted text is ~~struck~~).

Paragraph 2:

2. Paragraph 68(a) is met if (a) the notional amount of the swap and the principal amount of the hedged item <u>(or portion thereof)</u> match for each hedged interest payment for a cash flow hedge or match over the entire term of the hedged item for a fair value hedge, and (b) the notional amount of the fixed leg of the swap matches the notional amount of the variable leg of the swap throughout the life of the hedging relationship.

Paragraph 68(a):

a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged and the notional amount of the fixed leg of the swap matches the notional amount of the variable leg of the swap throughout the life of the hedging relationship. This requirement is also met if the notional amount of the swap and principal amount of the asset or liability <u>(or portion thereof)</u> match for each hedged interest payment for a cash flow hedge, even if the hedged item amortizes or otherwise adjusts subsequent to hedge inception. However a swap contract whose notional amount for each interest payment is based on the estimate rate of unscheduled prepayments (but does not exactly match the outstanding principal on the debt security) does not meet the requirement in this paragraph.

6. Other

ISDA recommends the following modifications to the proposed DIG Issue (inserted text is underlined and deleted text is ~~struck~~).

Paragraph 68(b):

3. Paragraph 68(b) is met for an interest rate swap that has a non-zero fair value at the inception of the hedging relationship provided that the swap was entered into at the hedge's inception for a transaction price of zero and the non-zero fair value is due solely to the existence of a bid-ask spread in the entity's ~~primary~~ principal market (or most advantageous market, as applicable) under FASB Statement No. 157, *Fair Value Measurements*.

Application of Paragraph 68(b) When the Transaction Price of Interest Rate Swap Is Zero

Paragraph 68(b) of Statement 133 previously required the fair value of an interest rate swap at the inception of the hedging relationship to be zero to meet that requirement for the shortcut method. Prior to the issuance of Statement 157, the fair value of a derivative that was entered into in the reporting entity's principal market was generally considered to be the transaction price (which is an entry price). Upon adoption of Statement 157, the fair value of an interest rate swap at initial recognition would be based on an exit price, as discussed in paragraph 31 of Statement 157, which likely would be other than zero due to the existence of a bid-ask spread. As a result, an entity might not pay or receive an amount at inception of the interest rate swap, but due to differences in the bid-ask spread in their ~~primary~~ principal market, the fair value at inception may be other than zero. The Board decided in this Implementation Issue that when a company enters into an interest rate swap with a transaction price of zero in its principal (or most advantageous) market, a difference between transaction price and fair value that is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction would not preclude application of the shortcut method