

March 9, 2011



Sir David Tweedie
International Accounting Standards Board
1st Floor
30 Cannon Street
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UK

Sent Electronically

File Reference No. ED/2010/13

Dear Sir David:

We appreciate the opportunity to comment on the IASB's Exposure Draft, *Hedge Accounting*, (the "Exposure Draft"). We have numerous clients that seek to apply hedge accounting to derivative transactions for which we are counterparty. While we have some concerns on the application of some of the guidance and on the clarity of some of the wording, we believe the Exposure Draft is a significant improvement over the existing US GAAP and IFRS hedge accounting standards and we would be supportive of the FASB adopting a similar framework for hedge accounting under US GAAP.

The IASB's standard starts at the right place; that is by looking to the entity's risk management activities to determine whether or not a derivative is intended to hedge a particular exposure and thus, whether it should be eligible for hedge accounting. In addition the Exposure Draft incorporates many of the improvements to FASB Statement No. 133 and IAS 39 that constituents have been calling for since their issuance – such as simplification of the effectiveness assessment and testing, the ability to hedge separately identifiable and reliably measurable risk components in non-financial assets and liabilities, and matching the time value of an option with the hedged transaction. Our main concerns center on the practical application of the linkage to risk management, as well as the notion of no-bias, and on required rebalancing. These are discussed in further detail in Appendix A.

Detailed comments on the Exposure Draft are set forth on the following pages. We hope that you find them helpful. Please contact either myself in New York at 212-902-7052 or Dean Galligan in London at 020-7774-1969 if we can be of further assistance or if you have questions about our comments.

Sincerely,

Tim Bridges

Timothy J. Bridges
Managing Director

Cc Dean Galligan, Goldman, Sachs & Co.
Matthew Schroeder, Goldman, Sachs & Co.

Appendix A

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

We agree with the proposed objective of hedge accounting to better align the reporting of hedging activity with an entity's risk management activities, but believe that it would be beneficial to clarify whether implementation of this objective would be expected to be on a macro basis, or on a more micro level, or at either level. For example, if the risk management objective is defined by a corporation as maintaining a current fixed-floating ratio of between 30% and 70%, we would contemplate that any derivative that resulted in a fixed-floating ratio within this range, or that moved the ratio closer to being in this range, would satisfy the requirement. Alternatively (but sub-optimally) the risk management strategy could be expressed as swapping a specific fixed rate liability to floating. We would observe that while a micro designation would likely be acceptable for many corporates that do not use derivatives extensively, it would be much more challenging for financial institutions and finance subsidiaries where risk management decisions are typically done on a portfolio or macro basis.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

We agree that non-derivative financial instruments measured at fair value through profit or loss should be permitted as eligible hedging instruments. If an entity chooses to manage a risk exposure by using a cash instrument, the effects of this risk management strategy should also be afforded hedge accounting.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree with the principle of permitting the designation of an aggregated exposure that is a combination of another exposure and a derivative as a hedged item. If an entity chooses to modify an existing risk management strategy by overlaying an additional derivative, the effects of this adjusted risk management strategy should be afforded hedge accounting consistent with the objectives of providing for hedge accounting.

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e. a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We agree with the IASB's decision to allow the designation of separately identifiable and reliably measurable risk components as the hedged item in hedges of both financial and non-financial assets and liabilities. Many of our clients have struggled with the fact that hedge accounting is not permitted for separately identifiable risk components of non-financial assets (and only certain

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components of financial assets). The IASB's change should eliminate needless complexity and align the accounting with the entity's risk management activities, as we believe it should be.

For example, an entity incurs fuel surcharges, based on changes in the price of gasoline, in its shipping costs. Under the current model, the hedged risk must be the total shipping costs, which often incorporate unhedgeable (and frequently unpredictable) factors such as the number of delivery location stops. Since these factors are not incorporated into the hedging derivative, at best they cause hedge ineffectiveness and at worst prevent the application of hedge accounting, despite the fact that the derivative would be considered highly effective if it is designated as a hedge of the fuel surcharge component only. They also make measuring ineffectiveness extremely complex. We believe the ability to designate risk components as hedged items will allow many more risk management hedges of non-financial items to qualify for hedge accounting.

We do not agree with the preclusion on hedging credit risk if it is separately identifiable and measureable. We believe that the broad principle should be applied to all risk components.

Question 5

- a) *Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?*
- b) *Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?*

Permitting the designation of a layer component of the nominal amount as the hedged item will help to allow entities to apply hedge accounting in the same way they are managing risk. Currently, IAS 39 F.2.17 permits partial term hedging - for example of the interest rate risk for the first 2 years of a 5 year bond (unlike FAS 133). Absent the ability to hedge a layer component, if an entity wants to hedge interest rate risk for the first two years of a five year fixed-rate bond and achieve hedge accounting, they would be compelled to execute (1) a five year swap to floating which is designated as a fair value hedge of the bond, and (2) a two year forward starting three year swap to fixed (which from a risk perspective nets with swap 1 to a two year swap to floating) which is either not designated as a hedge or designated as a cash flow hedge of an unrelated exposure. Continuing the guidance in F.2.17 in the new Standard we believe is critical. It would be more reflective of the entity's risk management strategy, not to mention simpler, to allow hedge accounting for the risk the entity is economically hedging, namely the interest rate risk for the first two years of the five year bond.

We also believe that the ability to hedge a top or bottom layer is a more sensible approach than the proportional approach. We do not believe that the existence of a prepayment option should preclude an item from being eligible to be included in a fair value hedge when the option's fair value is affected by the hedged risk, provided the entity is able to measure and quantify the effect of the prepayment option. To illustrate, an entity may own a mortgage security which contains a prepayment option. However, it is able to model the speed with which that security will prepay under different market circumstances. It may choose to hedge its main exposure to prepayment risk by hedging only the bottom layer with an option-based strategy (because that was the first layer that could get prepaid). Alternatively, it may define a top layer with little or no prepayment risk and be able to institute a fair value hedge of the interest rate risk of that portion (which would

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behave very similar to a bullet bond) with a forward-based derivative. We do not believe either strategy should be precluded.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

We agree with the decision to eliminate the quantitative 80 – 125% “bright line” test for qualifying for hedge accounting. We also agree with the decision to permit both qualitative and quantitative analyses for determining whether the qualifying criteria for hedge accounting have been met. Many hedging relationships can be determined to be effective on a qualitative basis based on the critical terms matching and as such, it does not seem necessary to perform a periodic quantitative analysis. The standard of other than accidental offset we believe is appropriate and consistent with the principle of basing hedge accounting on an entity’s risk management objectives.

We also recommend the IASB consider adopting a similar provision to that contained in the FASB’s proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* to eliminate an on-going assessment of hedge effectiveness.

However, we do not understand what is meant by the notion of “unbiased”. It could be interpreted to mean only a perfect hedge qualifies (which would be contrary to the overall thrust of the Exposure Draft) as it indicates that any bias is not acceptable at inception and on subsequent assessments. The notion of no bias also has the potential to add considerable busy work (constantly checking whether the hedging relationship has developed some bias over time) and this runs contrary to the objective of simplifying the hedge accounting framework. We believe that the over-riding principle of hedge accounting being driven by the entity’s risk management strategy should render the use of such a phrase redundant. For example, if an entity’s risk management strategy on a hedge is documented as being to swap the first 5 years of \$150mm of a \$200mm fixed rate bond to floating for 5 years, then the hedge relationship (i.e. how much of the bond is hedged) has already been defined.

Question 7

- a) *Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?*
- b) *Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?*

We do not agree with the requirement that a hedging relationship should be required to be rebalanced when the hedging relationship no longer meets the objective of the hedge effectiveness assessment but the risk management objective for the hedging relationship remains the same. While we would note that this is consistent with the notion of no de-designation, we believe that hedge accounting should be elective first and foremost. We believe that if a hedge

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ceases to achieve other than accidental offset, hedge accounting will have to cease unless the entity chooses to rebalance. As noted earlier we do not support the notion of no bias, and this notion seems to be a driver of the requirement to rebalance. As hedge accounting is applied prospectively, there is no ability to hardwire a particular outcome through de-designation or through what we believe the Board means by “bias”. In the vast majority of cases, entities will choose to rebalance a hedging relationship that no longer meets the objective of the hedge effective assessment, or that is being less effective than desired. However, we believe that rebalancing should be voluntary. We strongly support the notion that if rebalancing occurs, it should be viewed as a continuation of the existing hedging relationship. Treating such an event as a termination of one hedging relationship and the commencement of a new one has added considerable complexity and “busy work” to hedge accounting.

Question 8

- a) *Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?*
- b) *Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?*

Prospective discontinuation

We agree that hedge accounting should be discontinued on a prospective basis when the hedge relationship no longer meets the qualifying criteria. However, we believe that implicit in these criteria is that if an entity changes its risk management objective such that it no longer wishes to hedge the designated item, it should be able to (and in fact would be required) to de-designate a hedging relationship. Prospective discontinuation also precludes the ability to cherry pick when hedge accounting is applied.

Prohibition on de-designation

We do not agree with the prohibition on ceasing hedge accounting by de-designation of a hedging relationship. This provision completely contradicts a basic tenet of IAS 39 and FASB Statement No. FAS 133 – hedge accounting is elective. We are not aware of any abuse (for example, in terms of changing the timing of income statement recognition) that can be caused by the ability to de-designate a derivative. By imposing such a restriction, companies will face added complexity in their hedging strategies.

For example, one very common foreign currency risk hedging strategy is to hedge a forecasted foreign currency transaction as a cash flow hedge through the expected payment date and then de-designate the hedging relationship upon recognition of the transaction. This widely used hedge accounting strategy would no longer be permitted as it requires the company to de-designate a hedging relationship that would not meet the requirements for discontinuation of hedge accounting in the Exposure Draft. Providing the company’s risk management strategy provided for this, we believe that de-designation should be permitted.

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Question 9

- a) *Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognized in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?*
- b) *Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?*

We agree with the change to the mechanics of fair value hedge accounting. Separate balance sheet presentation of the cumulative change in fair value due to a fair value hedging relationship will provide more clarity for users by not distorting the carrying value of the hedged item. In addition, we agree that having the effective portion of fair value hedges presented in other comprehensive income will be helpful to users. This way they will not have to hunt through various financial statements to ascertain an entity's hedge accounting results.

However, we do not support the ED's proposal that the gain or loss on each hedged item (attributable to the hedged risk) should be presented as a separate line item in the statement of financial position. We do not believe that this provides any benefit but will add further crowding to already cluttered financial statements. While we support linked presentation on the balance sheet conceptually, we believe that this may be better achieved by having single line items within assets and liabilities representing hedge accounting adjustments to assets and liabilities, with the analysis of the components of the linked items being provided in the footnotes as opposed to on the face of the balance sheet. Alternatively, the current approach to adjusting the carrying value of the hedged item on the face of the statement of financial position could be retained, with the detailed analysis of the linked items provided in the footnotes.

Question 10

- a) *Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (e.g. like a basis adjustment if capitalized into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?*
- b) *Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?*
- c) *Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (i.e. the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?*

We agree with IASB's decision to mirror the treatment of option time value with that of the hedged transaction and to distinguish between the treatment of option time value associated with transaction related hedged items and option time value associated with time period related hedge items.

We believe the IASB's model in the Exposure Draft reflects the economics of option hedges. In transaction related hedges, an entity is typically hedging the risk of an adverse change in the price

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of a forecasted transaction. It is logical in this circumstance, to reflect the cost of the protection in the basis of the non-financial asset or liability acquired or in the period the forecasted transaction impacts earnings. Similarly, it is logical to recognize the cost of protecting against changes in a time period option hedge by amortizing the premium over the protection (option) period similar to the treatment of an insurance premium. However, we believe that the Board should clarify that the key principle is the matching of the option expense with the period in which the hedged transaction or item impacts earnings. For example, some believe that if a company is hedging the forecasted issuance of a ten year bond in six months' time with a purchased option, the ED would require that the premium be expensed over the period of time that the hedge is in place (6 months). We believe that the appropriate treatment is to recognize the premium cost over the period of time that interest expense will impact earnings (ten years).

We would suggest for the sake of clarity replacing the phrase “aligned time value” with “the time value of the hypothetical derivative”.

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

We believe the changes to the rules for hedging a closed portfolio are a step in the right direction. Most financial institutions manage risk on a portfolio basis, yet it is virtually impossible to achieve hedge accounting for a portfolio of items under current GAAP. The changes proposed in the Exposure Draft should allow entities to achieve hedge accounting for a broader array of portfolio risk management activities.

We would also observe that this issue is very closely linked with the macro hedge project and therefore any response on this topic is of necessity incomplete. Given the importance of this project to many financial institutions, we would strongly encourage the Board to expedite its work on this project.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (e.g. in a net position hedge), any hedging instrument gains or losses recognized in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

While not feeling strongly on this point, we do not agree that if offsetting hedged positions affect different lines of the profit or loss, then the hedge adjustment must be presented on a separate line. The risk management strategy will likely identify which line item is being “hedged, and consistent with other hedging relationships, it seems that the results from the hedging instrument should be reported in the line item in which the effects of the hedged item are reported.

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Question 13

- a) *Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?*
- b) *What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?*

No comments

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

We generally support this concept provided it is elective. If the entity identifies such a contract as being used in a fair value based risk management strategy, then derivative accounting would be appropriate. We do believe that making this accounting elective (i.e. it is only triggered if the entity identifies such a contract) is critical to avoid many of the issues around the definition of a derivative that arose under FAS 133. Provided it would be elective, we believe the Board should consider expanding the option to contracts that do not contain a net cash settlement alternative.

Question 15

- a) *Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?*
- b) *If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?*

We believe that it is important from a risk management (and therefore from a reporting) standpoint, for entities to have the ability to designate credit risk as an eligible risk component for hedge accounting. We believe that the Board should not explicitly exclude credit risk as being a separately identifiable risk. Implementation guidance could be given to indicate how this could be determined in practice. For example, for financial assets and liabilities it could be computed as the total change in fair value (or variability in forecasted cash flows) less the change attributable to separately identified risk components.

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

We agree that the proposed requirements be applied prospectively. We believe that a later mandatory effective date (for example January 1, 2015) would be more practical for entities to implement than 2013 given the other new accounting standards that they are likely to be implementing concurrently, but are supportive of this being one of the earlier new Standards adopted (if a staggered approach is adopted) and of early adoption being permitted.

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Other Comments

Hedging FX Risk in Intercompany Transactions

We disagree with the decision to prohibit hedge accounting of FX risk for certain forecasted intercompany transactions, such as royalties. We do not believe that such a change is consistent with the functional currency models in IAS 21 and FASB Statement No. 52. Further, such a change would have a drastic effect on the ability of companies following to hedge their foreign exchange exposures.