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August 15, 2008

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

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

Dear Mr. Golden:

The Group of North American Insurance Enterprises (GNAIE) appreciates the opportunity to offer our comments and observations on the Financial Accounting Standards Board's ("FASB") Exposure Draft of Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133* (the "ED").

GNAIE consists of the Chief Financial Officers of 18 leading insurance companies including life insurers, property and casualty ("non-life") insurers, and reinsurers. GNAIE members include companies that are among the largest global providers of life and non-life insurance and reinsurance products.

GNAIE supports the FASB's efforts to simplify the accounting for hedging activities and proactively address the practice issues that have arisen under FAS 133, *Accounting for Derivative Instruments and Hedging Activities* ("FAS 133") and its associated Derivative Implementation Issues ("DIG Issues"), as well as to focus on improving understandability of the accounting and reporting of hedging activities for financial statement users. GNAIE supports the Board's recommendation to eliminate the shortcut method and the critical terms matching concept in FAS 133, as numerous practice issues have arisen in this area due to their "rules-based" nature. This action is consistent with the Board's stated objective of moving to more principles-based standards and convergence, where appropriate, with International Financial Reporting Standards (IFRS).

**GNAIE**

Group of North American Insurance Enterprises  
40 Exchange Place, Suite 1707  
New York, NY 10005  
UNITED STATES

++1-212-480-0808  
info@insuranceaccounting.org  
www.insuranceaccounting.org



However, consistent with the Alternative Views expressed by certain Board members, we believe the ED fails in most other respects to adequately meet the FASB's stated objectives of simplifying the accounting for hedging activities, resolving major practice issues, and improving the understandability and decision usefulness of amounts reported and disclosed related to hedging activities.

GNAIE believes that the ability of an entity to designate individual risks should be retained for all hedged items currently eligible to be designated in benchmark interest rate hedges under FAS 133. Economically hedging "by risk" is the way many companies, including most insurance companies, manage risks in an effective and efficient manner. With the ability under FAS 133 to designate individual risks, the underlying economics of sound risk management practices, to the extent effective, are reflected in the financial statements in the same periods as the risk being managed. We do not believe removing the ability to designate individual risks will lead to an improvement or simplification of the accounting and reporting for hedging activities or lead to financial statements that are more understandable and decision useful to users.

Although we would support the lowering of the effectiveness threshold from "highly effective" to "reasonably effective," as the ED prescribes, we believe that more guidance, short of hard and fast rules or bright lines, is necessary in order to properly reduce numerous practice issues that may result and ensure consistent and comparable application of this guidance. We believe that the "reasonably effective" threshold will, in and of itself, simplify the application of hedge accounting and allow the accounting and reporting to be more closely aligned with the underlying economics and risk management strategies if, and only if, the ability to designate by individual risk is retained. In our opinion, without the ability to designate by individual risk, lowering the bar to "reasonably effective" will not achieve the Board's stated objectives.

The ED introduces new complexities and operational challenges that we believe will require more time to implement than contemplated by the Board. To this end, we encourage the Board to consider deferring the proposed effective date by one year in order for companies to review risk management and hedging strategies and to design and implement the appropriate systems and processes necessary to comply with the new guidance. In addition, we believe there will be numerous practice issues that will develop that will need to be addressed, given the experience with FAS 133, to assure that the new guidance is operational and will be consistently applied. If the Board ultimately decides to retain the ability to designate individual risks, there is a possibility that the proposed effective date will be achievable, depending on when a final standard is issued.

Our responses to the questions included in the ED's Notice for Recipients are included in Appendix A attached. If you have any questions or need clarification concerning any matter addressed in this letter, please contact Steve Belcher at 212-770-6252.

Sincerely,

A handwritten signature in black ink, appearing to read "Jerry de St. Paer". The signature is written in a cursive, somewhat stylized script.

Jerry de St. Paer  
Senior Vice President, Finance, AIG  
Executive Chairman, GNAIE



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

### **Hedged Risk**

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

Economically hedging "by risk" is the way many companies, including most insurance companies, manage risks in an effective and efficient manner. With the ability under FAS 133 to hedge individual risks, the underlying economics of sound risk management practices, to the extent effective, are reflected in the financial statements in the same periods as the risk being managed, thereby improving the usefulness of the financial statements. In GNAIE's view, if current risk management practices are continued despite eliminating the ability of an entity to designate individual risks (which we hope is the case), fewer risk management programs will qualify for hedge accounting (explained more fully in our response to Issue 2) and thus the usefulness of financial statements will most surely diminish, as the divide between the underlying economics and the related accounting will widen. We do not believe that the potential abandonment of prudent risk management practices is a desirable outcome of any accounting standard.

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

GNAIE believes that the FASB should retain its proposal to permit companies to designate the risk of changes in fair value or cash flows attributable to a benchmark interest rate or foreign currency exchange risk pertaining to their own debt. However, we also believe the Board should continue to permit an entity to designate individual risks for all hedged items currently eligible to be designated in benchmark interest rate hedges under FAS 133. The ability to designate individual risks is not, in our view, what makes FAS 133 complicated. As mentioned above, economically hedging "by risk" is consistent with the way companies manage risks. It may be optimal from a risk management perspective for a company to only hedge interest rate risk, for example, for a particular asset or group of assets. Elimination of the ability to individually designate risks being hedged may result in the abandonment of that particular risk mitigation strategy, because a company most likely will be forced to hedge other risks, such as credit risk, in order to achieve the "reasonably effective" criterion. Entering into a derivative transaction to mitigate credit risk, for example in this case, will often involve incurring such a cost that it negates the original purpose for purchasing the asset, that is, to earn a reasonable return for the risk assumed.

It is precisely for the reasons described above that the election of the fair value option under FAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities," is generally not a viable alternative to fair value hedge accounting by risk, because changes in fair value of the hedged item due to "other risks" are not mirrored by changes in the fair value of the economically optimal hedging instruments from a risk management perspective.

To summarize, we do not believe removing the ability to designate individual risks will lead to an improvement or simplification of the accounting and reporting for hedging activities or lead to financial statements that are more understandable and decision useful to users. We believe that lowering the hedge effectiveness assessment bar to “reasonably effective” will, in and of itself, simplify the application of hedge accounting and allow the accounting and reporting to be more closely aligned with the underlying economics and risk management strategies if, and only if, the ability to designate by individual risk is retained. In our opinion, without the ability to designate by individual risk, lowering the bar to “reasonably effective” will not achieve the Board’s stated objectives.

### **Hedge Effectiveness**

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

The ED uses the term “exactly” when describing the terms of the hypothetical derivative that should be used to measure ineffectiveness. This guidance will result in a change in practice for many companies that employ the well defined “hypothetical derivative method” outlined in Method 2 of DIG Issue No. G7, “Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method is not Applied”. The DIG Issue G7 hypothetical derivative method essentially requires that the key terms of the derivative and the underlying are matched, which appears to be a threshold that falls somewhat below “exactly match.” We encourage the Board to reconsider this guidance and maintain the DIG G7 hypothetical derivative approach, because it is well understood and major practice issues have been addressed and resolved. We do not believe that changing the rules, in this particular case, meets the Board’s objectives as outlined in the ED. In particular, we view this change as neither simplifying the accounting for hedging activities nor resolving major practice issues. Also, we are not convinced that this proposed change will improve the understandability or decision usefulness of the financial statements, given the relatively insignificant incremental difference between the value of a hypothetical derivative as measured currently under DIG Issue G7 and the more operationally challenging hypothetical derivative outlined in the ED.

Although we would support the lowering of the effectiveness threshold from highly effective to reasonably effective, we believe that more guidance, short of hard and fast rules or bright lines, is necessary in order to properly reduce numerous practice issues that may result and ensure consistent and comparable application of this guidance. If the Board ultimately decides to remove the ability to designate by risk, we believe without such additional guidance (particularly for financial assets and liabilities), financial statement preparers will be second-guessed and perhaps unnecessarily challenged by auditors and regulators, leading to an abandonment of hedge accounting due to the perceived “accounting risk” being too high. Additional guidance could be provided, for example, on several “plain-vanilla” hedging strategies used by a wide range of companies, to indicate circumstances in which a qualitative analysis may be sufficient. Additional guidance could also be provided, for example, to indicate the appropriate time horizon over which historical data should be viewed in order to determine quantitatively whether the proposed hedge will be reasonably effective.



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

GNAIE supports the Board's recommendation to eliminate the shortcut method and the critical terms matching concept in FAS 133, as numerous practice issues have arisen in this area due to their "rules-based" nature. This action is consistent with the Board's stated objective of moving to more principles-based standards and convergence, where appropriate, with IFRS.

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

GNAIE members are supportive of the proposed guidance that would lower the effectiveness threshold. However, we believe there will be limited benefits to this change, for preparers and users, if the Board ultimately decides to eliminate the ability of an entity to designate individual risks.

Although we would support the lowering of the effectiveness threshold from highly effective to reasonably effective, we believe that more guidance, short of hard and fast rules or bright lines, is necessary in order to properly reduce numerous practice issues that may result and ensure consistent and comparable application of this guidance. If the Board ultimately decides to remove the ability to designate by risk, we believe without such additional guidance (particularly for financial assets and liabilities), financial statement preparers will be second-guessed and perhaps unnecessarily challenged by auditors and regulators, leading to an abandonment of hedge accounting due to the perceived "accounting risk" being too high. Additional guidance could be provided, for example, on several "plain-vanilla" hedging strategies used by a wide range of companies, to indicate circumstances in which a qualitative analysis may be sufficient. Additional guidance could also be provided, for example, to indicate the appropriate time horizon over which historical data should be viewed in order to determine quantitatively whether the proposed hedge will be reasonably effective.

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

With the ability to hedge individual risks under FAS 133, the underlying economics of sound risk management practices, to the extent effective, are reflected in the financial statements in the same periods as the risk being managed, thereby improving the usefulness of the financial statements. Elimination of the ability to individually designate risks being hedged (particularly interest rate risk) may result in the abandonment of that particular risk mitigation strategy, because it will most likely "force" the hedging of other risks, such as credit risk, in order to achieve the "reasonably effective" criterion. Entering into a derivative transaction to mitigate credit risk, for example in this case, will often involve giving up such a substantial return that it negates the original purpose for purchasing the asset in the first place, that is, to earn a reasonable return for the risk assumed.

We also believe that requiring “own debt” hedges to be designated at inception to hedge only interest rate risk is an onerous requirement that will preclude many companies from aligning the accounting with their risk management strategies, which often involve mitigating such exposures when it is appropriate from an overall risk management perspective for the company. The optimal time to “hedge” will often not be upon initial issuance of any particular debt instrument.

As a practical matter, we believe that the Board should clarify the scope of the guidance on an entity hedging “its own issued debt or other borrowings” by simply referring to the hedged item as “any financial liability,” which we believe is the Board’s intent. We see no reason why the guidance would not apply to any financial liability, as issuer specific credit risk equally applies to all financial liabilities. Practice issues could also be avoided by this change because the term “financial liability” is clearly defined in the existing accounting literature, whereas “own debt or other borrowings” could potentially be subject to a wide range of interpretation, especially for financial services companies in the banking and insurance sector.

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

Depending on the extent to which credit spread changes will impact the hedged item, hedge accounting will most likely cease for reasons outlined in our response to Issues 1 and 4 above. In other cases, this could result in current risk management practices being altered. As mentioned in our response to Issue 2 the fair value option is generally not a viable alternative to fair value hedge accounting by individual risk, because changes in fair value of the hedged item due to “other risks,” such as credit, are not mirrored by changes in the fair value of the economically optimal hedging instruments from a risk management perspective.

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

If the Board ultimately decides to eliminate the ability to designate individual risks, we believe that our effectiveness testing will be more complex in that companies will have to monitor and evaluate effectiveness not only with respect to interest rate risk, but also with respect to other risks, such as credit and liquidity. Until companies have a better understanding as to how the “reasonably effective” threshold will be interpreted and applied in practice, absent any additional guidance from the Board, it is difficult to predict if significant operational issues will arise.

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

GNAIE does not believe that this new requirement will result in fewer hedging relationships being discontinued because some form of quantitative assurance on an ongoing basis will have to be provided to auditors, unless the Board provides additional guidance, as suggested earlier, with respect to what constitutes “reasonably effective.” Without additional guidance as to the definition of “reasonably effective,” we do not believe that there will be too many cases where a qualitative analysis alone would be sufficient, even at inception.



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

We agree with the Board’s decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective for the reasons outlined in the ED.

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

We believe that an effectiveness evaluation should be required in some form, at a minimum an effectiveness test should check to make sure that key terms of the hedging instrument and the hedged item continue to be in line with initial expectations such as notional amounts.

**Financial Statement Presentation**

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

We do not believe it is appropriate or necessary for Statement 133 to prescribe specific financial statement presentation. We believe that FAS 161, “Disclosures about Derivative Instruments and Hedging Activities”, adequately addresses this issue through more transparent disclosure, while still allowing flexibility to suit different overall financial statement presentations. The Board may want to consider including guidance previously promulgated by the Staff of the Securities and Exchange Commission as to where amounts should not be disclosed if “hedge accounting” is not achieved.

**Effective Date and Transition**

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

The ED introduces new complexities and operational challenges that we believe will require more time to implement than contemplated by the Board. To this end, we encourage the Board to consider deferring the effective date by one year in order for companies to review risk management and hedging strategies and design and implement the appropriate systems and processes necessary to comply with the new guidance. For example, some companies will be required to measure ineffectiveness using the “long haul” method and lack the ability or expertise to perform those calculations, having always applied the shortcut or critical terms matching approach. In addition, we believe there will be numerous practice issues that will develop that will need to be addressed given the experience with FAS 133, to assure that the new guidance is operational and will be consistently applied. If the Board ultimately decides to retain the ability to designate individual risks, there is a possibility that the proposed effective date will be achievable, depending on when a final standard is issued.



Consistent with the Alternative Views expressed by two Board members in the ED, from both a preparer and a user perspective, we are finding it difficult to understand why such a significant change to FAS 133 hedge accounting is being contemplated at a time when (1) the changes outlined in the ED, generally result in a divergence from IFRS, (2) U.S. companies, beginning with the large public filers, are on a potential path to switching to IFRS within a few short years and (3) the IASB and the FASB are in the process of reconsidering the entire framework for financial instruments in a joint effort to reduce complexity as outlined in the IASB's Discussion Paper, "Reducing Complexity in Reporting Financial Instruments," and the FASB's related Invitation to Comment.

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

GNAIE does not believe that there is a need for specific disclosures that should be required during transition.

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

GNAIE supports the Board's decision to allow a one-time fair value option at the initial adoption of the proposed Statement. However, if the proposed changes are implemented as drafted, we believe the Board should not limit the items that are eligible under this election to those items for which a hedging relationship exists prior to the initial application of the new guidance. This is consistent with the Board's previous decision to allow a "one-time" reclassification of categories under FAS 115 upon adoption of FAS 133 and [insert others].

### **Benefit-Cost Considerations**

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

In the ED, the FASB has concluded that the ongoing benefits of the ED's proposed revisions to the accounting model for hedging activities would exceed the one time costs to implement the changes. In GNAIE's view, the benefits of the ED's proposed revised accounting model are limited. We not believe that the proposed changes significantly reduce complexity and, in fact, may result in financial statements that are less understandable when entities wish to maintain their current risk management practices and are no longer able to obtain hedge accounting due to the inability to designate individual risks.

GNAIE also challenges whether such significant changes to FAS 133 are appropriate at this time, given the potential migration of public companies in the US moving to IFRS within a few short years and the potential for IFRS to change again, depending on the results of the overall project on financial instruments.