



April 25, 2011

Ms. Susan Cospers  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: File Reference No. 2011-175

Dear Ms. Cospers:

Capital One Financial Corporation is a diversified financial services company with over \$199 billion in assets that offers a broad spectrum of banking products and financial services to consumers, small businesses, and commercial clients. We appreciate the opportunity to provide comments on the Discussion Paper, *Selected Issues about Hedge Accounting (Including IASB Exposure Draft, Hedge Accounting)* (the “Discussion Paper”), recently issued by the Financial Accounting Standards Board (the “FASB”).

We support the FASB and the International Accounting Standards Board’s (“IASB”) effort to improve and simplify standards for financial reporting of financial instruments, and in particular, derivatives and hedging activities. By reference to our comment letter dated September 1, 2010, we note that we were generally supportive of the principles-based approach that the FASB employed in the revisions to hedge accounting as described in the Proposed Accounting Standards Update, Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815), *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the “Proposed Update”), although we did have some specific areas of concern and suggestions for improvement. Similarly, we are generally supportive of the objectives-based approach in the Discussion Paper to align hedge accounting more closely with risk management. We have not fully considered every aspect of the Discussion Paper or responded to all of the Questions for Respondents; however, we have highlighted some of the concepts that we support as well as our points of concern. We encourage the FASB and the IASB to continue considering how best to improve the accounting for hedging activities by evaluating the strengths and weaknesses of each respective model exposed by the Boards, as well as additional concepts suggested by constituents, including ourselves.

### **Specific Comments on the Discussion Paper**

#### **What We Support**

- **We ask the FASB to consider removing or expanding its definition of allowable “benchmark interest rates.”** Although this issue is not specifically highlighted in the Discussion Paper, our interpretation of both current IFRS and the Discussion Paper is that they permit greater flexibility in hedging interest rates than what is currently permitted under US GAAP due to the restrictions of what may be considered a “benchmark interest rate.” Interest rate risk related to changes in fair value or variability in cash flows of financial instruments due to changes in the prime rate, federal funds rate, commercial paper rate, IOR (interest on excess reserve), CMT (constant maturity Treasury), and many others, are both

separately identifiable and reliably measurable. Allowing greater flexibility in the hedging of interest rate risk would certainly advance the Boards' objective of simplifying financial reporting and providing users with clearer and more complete information that aligns with the way that we manage our business.

- **We support the accounting for cash flow hedges as described in the Discussion Paper.** In our comment letter dated September 1, 2010, we asked that the FASB reconsider its decision in the Proposed Update to require that ineffectiveness be recorded on under-hedges of forecasted cash flows. The requirements in the Discussion Paper for recognizing ineffectiveness in cash flow hedges are consistent with current US GAAP and current IFRS, and we do not believe that a change is needed.
- **We encourage the designation of credit risk be permitted as an eligible risk component.** Paragraph BC225 of the IASB Exposure Draft states that, "...measuring the credit risk component of a loan or a loan commitment is complex. Consequently, to accommodate hedge accounting for hedges of credit risk, a different hedge accounting requirement specifically for this type of risk component would have to be developed, or the proposed hedge accounting requirements would have to be significantly modified." We believe the principles-based guidance that requires the risk to be separately identifiable and reliably measurable is sufficient. Furthermore, US GAAP already includes measurement models that attempt to isolate changes in fair value solely due to credit risk, such as the calculation of impairment for loans and securities. Credit derivatives can serve as a valuable risk management tool, so permitting the designation of credit risk as an eligible risk component would advance the objective of aligning hedge accounting with risk management activities. We believe that the establishment of a different model for hedging credit risk would add unnecessary complexity and goes against the objective of simplifying financial reporting.

Although not specifically addressed in the Discussion Paper, in addition to credit risk, we believe that any final guidance should explicitly permit hedges of prepayment risk and basis risk when they meet the same qualifying criteria as other risks. Managing all of these risks is an essential component of managing financial instruments that are issued or acquired through customer financing activities. Permitting these types of risks to be hedged would serve to further align hedge accounting with risk management activities.

- **We support the proposal that a layer component of the nominal amount of an item should be eligible for designation as a hedged item.** However, we disagree with the prohibition on designating a layer component of a contract that includes a prepayment option as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. This would effectively preclude hedges of changes in the fair value of layer components of prepayable financial instruments, such as mortgage loans and mortgage servicing rights, due to changes in interest rates. Such preclusion would be inconsistent with the way that an entity manages risk.
- **We support the expansion of the types of items that may be designated as a hedged item to include aggregated exposures.** Allowing entities to combine an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk (or risks) would align hedge accounting more closely with our risk management strategies. The example in paragraph B9 of the IASB Exposure Draft, *Hedge Accounting* ("IASB Exposure Draft"), is illustrative of a potentially prudent risk management strategy that we would consider implementing if hedge accounting were permitted.

Although we are supportive of the expansion of the types of items that may be designated as hedged items, we believe that additional clarification may be needed with regard to the presentation of hedging instrument gains and losses, as well as presentation of fair value changes attributable to the hedged risk in the statement of financial position, for these types of hedge strategies. Similarly, clarification may also be needed for presentation matters related to hedges of net positions.

### **Our Concerns**

- **We believe that de-designation of hedging relationships should be elective.** The IASB Exposure Draft states that an entity may only discontinue hedge accounting when the risk management objective of a hedging relationship is changed or when a hedging relationship ceases to meet the qualifying criteria. The ability to de-designate hedges to adapt to changing business strategies, balance sheet changes, interest rate changes, and economic conditions is essential to managing our overall risk position. Since the IASB's objective was to align hedge accounting with risk management strategies, we believe that there should be no restrictions on situations in which an entity may de-designate a hedging relationship.
- **We request clarification of the Discussion Paper's hedge effectiveness requirements.** The IASB Exposure Draft states that the hedging relationship must (a) meet the objective of the hedge effectiveness assessment (that is, to ensure that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness) and (b) be expected to achieve "other-than-accidental offset." Although we support the IASB's effort to assess hedge effectiveness on a basis other than "highly effective," we believe that the proposed requirements may lead to diversity in practice without additional clarification. For example, when considering a hedge strategy, management may consider a variety of hedging instruments with varying market conventions and transaction costs. The requirement to "minimize expected hedge ineffectiveness" may lead some to interpret that management is required to select the hedging instrument with the best possible offset, without consideration for marketplace convention or transaction costs. It could also be interpreted to mean that only hedges with an expectation of perfect effectiveness are permitted, similar to those that are accounted for using the shortcut method or critical terms match under current US GAAP. We do not believe either of these interpretations would be consistent with the IASB's intent, but we request that consideration be given to clarifying such guidance in order to avoid challenges in practice.

We note that we are supportive of the shift to a qualitative assessment of effectiveness and the elimination of the need for a retrospective assessment of effectiveness. A prospective, qualitative assessment of hedge effectiveness is more consistent with an entity's risk management strategy.

- **We disagree with the proposed accounting for the time value of purchased options.** We believe that US GAAP is more closely aligned with an entity's risk management strategy in certain situations by permitting the entity to focus on the terminal value of an option in a cash flow hedge, in which case the time value of the option is deferred in other comprehensive income and amortized to profit or loss over the period of the hedge. That concept does not appear to be contemplated in the Discussion Paper. Furthermore, if the intrinsic value of the purchased option is designated as the hedging instrument and the hedged item is transaction-related, the initial time value of the option may be recorded in the initial cost or other carrying

amount of the item. This result seems counterintuitive and does not serve to simplify financial reporting.

- **We ask that the FASB consider transition provisions that allow for grandfathering of existing hedge relationships.** The Discussion Paper does not consider any transition provisions for the changes to the accounting for derivative instruments and hedging activities. Regardless of whether the final standard on hedge accounting resembles the model in the Proposed Update, the IASB Exposure Draft, or something else, we suggest that the consideration be given to requiring prospective application only. Retrospective application would place an undue burden on preparers to reevaluate existing hedge relationships even though their risk management strategies may not have changed since the inception of the hedges. For example, neither of the proposed models permit the shortcut method as currently provided in US GAAP and it is not clear what the impact on existing shortcut method hedging relationships will be.

If you have any questions about our comments, please contact Pam Koch at (804) 284-0152.

Sincerely,



Susan McFarland  
Executive Vice President and Principal Accounting Officer