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Morgan Stanley

April 25, 2011

Susan M. Cospers
Technical Director
File Reference No. 2011-175
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: FASB Discussion Paper – Selected Issues about Hedge Accounting

Dear Ms. Cospers:

Morgan Stanley appreciates the opportunity to comment on the FASB Discussion Paper, *Selected Issues about Hedge Accounting* (the “DP”). We have also directly responded to the IASB Exposure Draft, *Hedge Accounting* (the “IASB ED”), which underlies the questions posed in the DP. Furthermore, we contributed to the letters submitted by the International Swaps and Derivatives Association (“ISDA”) to each of the FASB and the IASB and are generally supportive of the views expressed therein.

We are supportive of the efforts of the FASB (“the Board”) and IASB (collectively, “the Boards”) to pursue a common approach to hedge accounting and commend the FASB for seeking views on the proposals put forth in the IASB ED. Overall, we continue to encourage the simplification of hedge accounting and support principles-based standards. However, we are concerned with the divergence between the proposals previously published by the FASB in the FASB Exposure Draft, *Accounting for Financial Instruments and Revisions to Accounting for Derivatives and Hedging Activities* (the “FASB ED”), and those in the IASB ED. We believe that components of each of the separate models contain merit, but that further work should be done to develop a single hedge accounting model for both U.S. GAAP and IFRS. We understand that the hedge accounting model of each Board must be consistent with the respective classification and measurement model. Therefore, we strongly encourage the Boards to continue to collaborate on the development of a comprehensive model for financial instruments, including hedge accounting, in order to eliminate differences.

As it relates to the proposals in the IASB ED, we are supportive of the alignment of risk management activities with hedge accounting. We believe that the removal of the

threshold for purposes of effectiveness testing, the increase in eligible hedging instruments and hedge items, including risk components, groups of items and net positions, as well as the ability to proactively rebalance a hedge relationship without the requirement to de-designate the existing relationship are all positive steps in meeting this objective. We are supportive of the FASB's requirement that a hedge be expected to be "reasonably effective" in offsetting gains and losses of the hedged item. We do, however, have a number of concerns with the provisions in both the IASB ED and the FASB ED and believe that further outreach and re-deliberation is necessary before a final standard is issued. Our principal concerns as they relate to components of both the IASB and the FASB models are as follows:

- *Potential mismatch between risk management strategies and hedge accounting:* We are concerned that, as written, the IASB ED may require risk management strategies to be documented at a micro or individual hedge level. Most corporate risk management policies are intended to address risk management activities undertaken by a firm at a level that is higher than an individual transaction level. We do not believe that risk management strategy should be considered at the individual transaction level.
- *Clarity of new concepts introduced in the IASB ED:* The IASB ED could benefit from clearer articulation of many of the new concepts introduced. In particular, we believe that the concepts of "unbiased" and "other-than-accidental offset" within the objective of hedge effectiveness need further refinement, as do the requirements related to rebalancing. We propose a converged hedge accounting model whereby a hedge effectiveness assessment is based on the expectation that a hedge will be "reasonably effective" in offsetting gains and losses related to the hedged item, as was put forth in the FASB ED. We are also concerned about the operability of rebalancing as proposed in the ED and believe that rebalancing should not be mandatory unless triggered by risk management action. Mandating rebalancing is contradictory to the overall objective of the ED to link risk management activities to hedge accounting.
- *Designation of risk components:* We agree with the proposals to permit a broader range of risk components as eligible hedge items for non-financial items where they are separately identifiable and reliably measurable. Furthermore, we believe this principle should be equally applicable for financial items and their risk components, e.g. credit risk, and urge the Boards to expand this principle to include financial items. From a U.S. GAAP perspective, as mentioned previously in our comment letter in response to the FASB ED, the definition of the benchmark interest rate is rules-based and we recommend that the Board take this opportunity to expand the definition to allow for hedges of identifiable and reliably measurable interest rate exposures. We are particularly concerned with lack of convergence on this issue as the result would be lack of comparability whereby certain economic hedge strategies qualify for hedge accounting under one regime, but not the other.

- *Ability to voluntarily de-designate hedge relationships:* We believe the prohibition against voluntary de-designation of hedges is inconsistent with the principle of aligning risk management strategies and hedge accounting. Furthermore, the application of hedge accounting is elective and we believe that termination should also be elective so that the model is symmetrical.

- *Presentation of fair value hedges:* We do not agree with the requirement to recognize gains and losses on the hedged item and hedging instruments in OCI for fair value hedges. Gains and losses associated with fair value hedges will impact the current period so recognition in current period earnings is appropriate. We also disagree with the proposal to require separate presentation in the balance sheet of the fair value change attributable to the hedged item. We do not believe that this information will help users of financial statements and we are concerned that this will result in a cluttered balance sheet. We believe current disclosure requirements under U.S. GAAP are the appropriate means by which to convey this information.

In conclusion, we are supportive of a single converged hedge accounting model that simplifies hedge accounting and contains the flexibility necessary to align hedge accounting with risk management strategies. We are concerned that neither the FASB nor the IASB model satisfies this requirement as currently proposed and believe each of the models contains components which are preferable to the other. Thus, we recommend that the Boards work together to develop a single model which further aligns hedge accounting with risk management strategies.

Our detailed responses to the questions raised in the DP that are significant to Morgan Stanley are in the Appendix to this letter. Again, we thank you for the opportunity to provide comments. Please contact me at 212-276-7824 or Mona Nag at 212-276-5129 if you have any questions.

Sincerely,



G. David Bonnar
Managing Director
Global Accounting Standards and Control

Appendix

Below are more detailed responses to those questions raised in the DP that are significant to Morgan Stanley.

Question 2: Do you believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?

Answer: We are generally supportive of the principle expressed in the IASB ED to align hedge accounting with risk management strategies and believe a standard which results in operationally practical hedge accounting for an increased scope of risk management strategies is beneficial for users to understand an entity's risk management approach. However, we are not certain how the linkage will need to be demonstrated or documented and are concerned that the disparity between risk management strategies executed at a macro level versus hedge designations at a transaction level will create practical and operational challenges in demonstrating linkage between the two. We do not believe that risk management strategy should necessarily be documented on a hedge-by-hedge basis as it will result in introducing new complexity to hedge accounting. We are further concerned that on an ongoing basis, it will be difficult to identify when changes in risk management strategy should have an impact on hedge accounting. Risk management inherently includes adjustments and assessments at a macro level, but these adjustments may be within the overall strategy and therefore should not necessarily impact hedge accounting. However, further guidance would be needed to understand how to treat differences between the risk management strategy level and the hedge accounting designation level.

Question 3: Do you foresee an entity changing how it determines, documents, and oversees its risk management objectives as a result of this proposed guidance? If yes, what changes do you foresee? Do you foresee any significant difficulties that an entity would likely encounter in establishing the controls related to complying with the proposed guidance?

Answer: As mentioned above, we are concerned with the disparity between risk management strategy, which is often at a more macro level, and hedge designations at a more micro level. We do not believe that the requirements of hedge accounting should drive an entity's risk management approach. Rather, hedge accounting principles should be reflective of prudent risk management strategies. We believe the latter is the IASB's intention, but are not confident their proposal clearly articulates or demonstrates how an entity would demonstrate compliance with the principle. Therefore, we recommend that the principle be further developed such that the disparity between macro risk management strategies and micro hedging designations does not result in either a change to risk management strategies, documentation of risk management at the individual transaction level, or a disallowance of hedge accounting based on perceived changes in an entity's risk management strategy. Overall, we are supportive of an underlying

principle that hedge designations should be consistent (or not inconsistent) with risk management strategies.

From a controls perspective, there would need to be linkage between risk management functions and hedge accounting management. If the hedge accounting principle is properly designed in a way that permits hedge accounting based on overall risk management strategies, we expect that the appropriate controls could be put in place without significant difficulty because of the alignment with how the business is managed from an economic perspective. It is unclear whether risk management and hedge accounting need to be perfectly aligned (irrespective of costs and operational burden) and whether any degree of tolerance is permissible to accommodate differences.

Question 4: Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity's risk management strategies measurable and objective? Could the inclusion of an entity's risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of an entity's risk management objectives?

Answer: As noted, risk management strategies are often executed at a macro level. Therefore, there is the potential that a more narrow view, such as at the more granular hedge relationship level, might give the impression that management has deviated from its risk management objective. We are concerned that this disparity may result in auditors questioning compliance with the original risk management strategy when, in fact, rebalancing at the hedge relationship level is considered by the entity to be within the macro level risk management strategy. The alternative is that risk management strategy would have to be documented at the same level as hedge designations so that they are more directly linked and leave less room for variances between the two. However, as mentioned above, we do not support a hedge accounting principle that results in changes to risk management strategies as this seems counter to the overall intention of alignment expressed in the IASB ED.

The IASB ED implies that risk management strategies are in line with the prescribed objective of the hedge effectiveness assessment, which is to "produce an unbiased result and minimize expected hedge ineffectiveness." However, there are prudent and common risk management strategies which are not focused on the minimization of ineffectiveness, but rather on transformation of risk. There are also reasonable hedge strategies which seek to reduce a particular risk type but are not necessarily unbiased due to the selection of the hedge instrument, which considers factors such as cost and availability. Further, what might be a reasonable hedge in terms of the overall risk management strategy may not necessarily be unbiased or minimize ineffectiveness at the hedge relationship level. Therefore we are greatly concerned that it will be difficult for auditors to assess compliance with hedge accounting in cases where the stated objective of hedge effectiveness as discussed in the IASB ED is not identical to the overall risk management strategy of an entity. As discussed in question 15, we are also greatly concerned by the

possibility of a strict interpretation of the concept of a strategy that is unbiased and minimizes hedge ineffectiveness.

Question 5: Should cash instruments be eligible to be designated as hedging instruments? Why or why not? If yes, is there sufficient rigor to prevent an entity from circumventing the classification and measurement guidance in other relevant accounting guidance (for example, IFRS 9, *Financial Instruments*, and IAS 21, *The Effects of Changes in Foreign Exchange Rates*)? Are there any operational concerns about designating cash instruments (such as items within a portfolio of receivables) as hedging instruments?

Answer: We are generally supportive of the expansion of items which are eligible to be designated as hedges if they are expected to be effective in offsetting the hedged risk, including non-derivative instruments. While not expected to be utilized frequently, it may be a useful and cost effective option to align hedge accounting with the risk management activities of an entity. We believe this is a positive move towards a more principles-based model as it removes a specific exception.

Question 6: Do you believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item (for example, equity instruments measured at fair value through profit or loss, standalone derivatives, hybrid instruments, and components of instruments measured at fair value through profit or loss that are not permitted to be bifurcated)? If not, what additional guidance should be provided?

Answer: The IASB ED is not clear whether debt host instruments from which an embedded derivative has been bifurcated would be eligible as hedge items. However, we believe that because the host contract is separately accounted for that it should be an eligible hedged item.

Question 7: Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided.

Answer: We are generally supportive of the ability to designate a component of an instrument as a hedged item. We support a principle which broadly provides the ability to bifurcate risks that are “separately identifiable” and “reliably measurable.” We are, however, particularly concerned by the divergence in current accounting rules as it relates to bifurcation-by-risk for financial instruments, and the fact that the FASB ED and the IASB ED appear to remain divergent on this issue.

Under IFRS, for financial instruments, any risk which can be separately identified and reliably measured, including any separately measurable portion of interest rate exposures, can qualify as the hedged item. However, U.S. GAAP defines an eligible

hedged risk as full fair value, credit risk, benchmark interest rate risk or foreign currency exposure. The guidance in U.S. GAAP is further restrictive in that the benchmark interest rate is defined as LIBOR or Treasury rates. As mentioned previously in our comment letter in response to the FASB ED, the narrow definition of the benchmark interest rate is rules-based and we recommend that the Board take this opportunity to expand the definition to allow for hedges of identifiable and reliably measurable interest rate exposures. Entities regularly enter into economic hedges of non-benchmark interest rates and we believe hedge accounting should be more widely available to reflect such risk management strategies.

Within the IASB ED, we do not support the prohibition of specific risks as eligible components (e.g., credit risk), as this is rules-based and seems to be in conflict with other accepted accounting principles, such as fair value measurements that incorporate credit risk. Credit risk is specifically identifiable and is routinely hedged in common risk management strategies. It is also reliably measurable, which is inherently acknowledged in fair value measurement principles given that entities are required to consider counterparty and own credit risk and separately disclose the impact of such risks. The use of bond and credit default spreads are reliable indicators of credit risk and can be used to measure credit risk. Therefore, we believe the prohibition against specific risks should be removed as it is inconsistent with the overarching principle of the model, which is to align hedge accounting with risk management.

We highly support convergence on this issue as there are widespread differences between the current U.S. GAAP and IFRS models as well as the respective proposals put forth by the Boards, and propose a model whereby separately identifiable and reliably measurable risks are eligible to be designated as hedged items.

Question 10: Do you believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population? (For example, do you believe that the sale of the last 10,000 widgets sold during a specified period could be designated a layer component in a cash flow hedge?) If not, what additional guidance should be provided?

Answer: We are supportive of the ability to identify a specified layer of a group of items as a hedged item. However, we believe further guidance is required in order to understand how a layer in an open population must be defined in order to be eligible. One could take the view that a layer that is only identified by the passage of time would not qualify because the items within the group which would be included as the hedged layer would not be specifically identifiable at the time of the designation of the hedge. However, an alternate view would be that while the specific items within the group may not be identified until a later point, because the hedged risk of all the items is the same, the specific items need not be known in advance as long as the layer itself is appropriately defined. The terms “defined” and “open” as used in the IASB ED are potentially contradictory and we recommend that the guidance be clarified.

Question 12: Do you believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity's use of derivatives? Why or why not?

Answer: We are generally supportive of principles for hedge accounting that align with how an entity manages its business. The proposed guidance on aggregated exposures represents significant progress in aligning risk management and hedge accounting. Because there are reasonable risk management strategies for economically hedging aggregated exposures, we support the availability of hedge accounting for such strategies and believe it would provide more transparent information regarding the use of derivatives. Therefore, we believe aggregated exposures should be eligible as hedged items if supported by the appropriate documentation and disclosure.

Question 14: Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them?

Answer: We understand the concept that it would be inappropriate to designate a hedge and assert that it is expected to be effective if there was no relationship between the hedged item and the hedged instrument other than coincidence, or "accidental offset." However, we are concerned with the limited guidance in the proposal as to how "other-than-accidental offset" could be asserted, and that in practice, this will lead to the introduction of bright lines or rules-based guidelines. To eliminate confusion, we would recommend that concepts and phrases such as "other-than-accidental offset" be deleted entirely and replaced with the "reasonably effective" hedge qualification criterion included in the FASB ED. We believe the Boards' overall intention is to relax the burden of complying with hedge accounting, but are concerned that the terminology as used in the IASB ED could have the opposite effect once interpreted in practice.

Question 15: Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness (for example, how to measure the change in the value of the hedged item attributable to the related hedged risk for nonfinancial items)? If not, what additional guidance is needed?

Answer: We are supportive of the simplification of the assessment of hedge effectiveness, including the provisions for qualitative assessments at inception and only prospective assessment, as well as the elimination of the 80-125% "bright line" used to determine whether a hedge qualifies for hedge accounting under a quantitative assessment of effectiveness. However, we are concerned that the hedge accounting objective, which would be considered in determining effectiveness, is unclear, particularly as it relates to the concepts of "unbiased" and "minimiz[ing] ineffectiveness." These concepts are not adequately explained and, depending on interpretation, could be in conflict with an entity's risk management strategies. One extreme interpretation could be that all bias must be eliminated and all ineffectiveness minimized. This outcome is contrary to the IASB's objective of reducing complexity. As mentioned previously, while we support the alignment with risk management in concept, the proposals with regards to

the objective of hedge effectiveness assessments are largely unclear and could potentially lead to hedge accounting driving risk management, rather than vice versa.

Therefore, we believe the “reasonably effective” principle in the FASB ED is better aligned with the objective to simplify hedge accounting as compared to the proposals in the IASB ED with respect to effectiveness assessments. This is a point on which convergence could be reached in a manner that reduces the potential for disparate interpretation in practice. We are also supportive of the provision in the FASB ED to require ongoing effectiveness assessments only if circumstances have changed such that the hedge may no longer be expected to be “reasonably effective,” as opposed to the IASB’s requirement for ongoing assessment to be, at a minimum, performed at each reporting period.

Question 16: Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity’s risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them?

Answer: We are generally supportive of the ability to modify a hedge relationship, without de-designating and re-designating, which is operationally and administratively burdensome, in order to improve the economic results of the hedge. However, we are concerned with the provision in the proposal that would require rebalancing of hedge relationships and are instead supportive of a provision that would permit rebalancing. Because the application of hedge accounting is elective, we support a symmetrical model whereby de-designation is also elective, and believe the requirement to rebalance is contrary to the elective nature of hedge accounting and is inconsistent with the guiding principle of alignment with risk management.

While we do not support the requirement to rebalance, we also find the IASB ED to be unclear as to when rebalancing would be required. The key criterion to achieve hedge accounting is that the hedge relationship produce an unbiased result and minimize ineffectiveness. If the effectiveness assessment indicates that bias exists or ineffectiveness is not minimized, then the proposal requires an entity to rebalance the hedge relationship such that the bias is eliminated or ineffectiveness is minimized. We believe one interpretation could be that rebalancing may be required in circumstances where the risk management objective has not changed, but where there could be a hedging instrument which would reduce ineffectiveness. This would result in operational burdens and additional costs above and beyond what would be expected based on risk management objectives. We are also concerned that the requirement to rebalance might contradict the Boards’ objective to simplify the hedge accounting. It is unclear whether the mechanics of rebalancing might actually lead to added complexity in practice and we suggest further guidance be provided.

Finally, as mentioned above, we are unclear what might be considered a change in risk management strategy, which would require de-designation, because of the disconnect between macro risk management and granular hedge relationship designations.

Question 17: Do you foresee any significant operational concerns or constraints relating to the potential need to rebalance the hedging relationship to continue to qualify for hedge accounting? If yes, what concerns or constraints do you foresee and how would you alleviate them?

Answer: As noted above, although we are supportive of the IASB's proposal to allow for changes to a hedge relationship by a rebalancing exercise, because we are unclear on when rebalancing would be required, we are concerned that significant costs could be incurred in adjusting hedging instruments. There would be operational burdens associated with determining when rebalancing would be required (i.e. when the hedge objective is no longer met) on an ongoing basis, and we do not believe the cost is warranted as it is contrary to the high level aim of the IASB ED, which is to simplify hedge accounting and provide a better linkage between an entity's risk management strategy and hedge accounting.

Question 19: Do you believe that the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more useful information? Why or why not?

Answer: We are not supportive of the requirement to recognize gains and losses on the hedged item and hedging instruments in fair value hedges in OCI because we do not believe this is meaningful information for fair value hedges. This is a reasonable presentation difference between fair value and cash flow hedges, for which gains or losses are recognized in OCI because gains and losses of the hedged item will impact earnings in future periods, whereas gains and losses associated with fair value hedges will impact current period earnings.

Question 20: Do you believe that the proposed presentation of a separate line item in the statement of financial position would increase the transparency and the usefulness of the information about an entity's hedging activities? Why or why not?

Answer: We do not support the proposal that gains and losses associated with the hedged item should be separately presented on the balance sheet. These amounts do not meet the recognition criteria as separate assets and liabilities and the reflection of positive and negative balances on both sides of the balance sheet is overly complex. The disclosures of these amounts as required by current U.S. GAAP is adequate and we do not believe that separate presentation on the balance sheet would be an improvement in financial reporting.

Question 23: Do you believe that the changes proposed by the IASB provide a superior starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP

or moving toward converging its overall standards on derivatives and hedging activities with the IASB's standards?

Answer: Overall, we are supportive of a single converged hedge accounting model that simplifies current hedge accounting models under both U.S. GAAP and IFRS, and which contains the flexibility necessary to align hedge accounting with risk management strategies. We believe that there are components of each of the FASB ED and the IASB ED which are superior.

As proposed by the IASB, we support the alignment of hedge accounting with risk management strategies, the expansion of items and instruments eligible for hedge accounting, and the ability to rebalance a hedge relationship. However, we believe further work must be done to clarify how risk management and hedge accounting will be linked in practice, given the divide between macro level risk management strategies and micro level hedge relationship designations. We also do not support the specific prohibition against certain risks as eligible components which may qualify as hedged items. Finally, we do not support mandatory rebalancing and are unclear as to when it would even be required because we believe the terms "unbiased" and "minimize ineffectiveness" could be interpreted in such a way as to make effectiveness assessments more restrictive than in current practice. From the FASB ED, we support the relaxation of the hedge effectiveness assessment such that a hedge which is qualitatively expected to be "reasonably effective" would qualify for hedge accounting, and the requirement to reassess effectiveness only when circumstances have changed. We also suggest that the FASB do more to expand the bifurcation-by-risk approach such that the guidance is based on a principle whereby separately identifiable and reliably measurable risks are eligible to be hedged items, specifically with respect to the definition of benchmark interest rates.