



April 25, 2011

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

File Reference: No. 2011-175, *Selected Issues about Hedge Accounting (Including IASB Exposure Draft, Hedge Accounting)*

Dear FASB Board Members and Staff:

The PNC Financial Services Group, Inc. ("PNC") appreciates the opportunity to comment on the Discussion Paper, *Selected Issues about Hedge Accounting (Including IASB Exposure Draft, Hedge Accounting)*, which solicits feedback on the International Accounting Standards Board's (IASB's) proposed changes with regard to hedge accounting.

PNC agrees with the IASB's stated objective to align hedge accounting more closely to an entity's risk management strategies. We also agree with establishing a more objective-based approach to hedge accounting, as well as addressing inconsistencies and weaknesses in the existing hedge accounting model. However, we are concerned about a number of principles presented including: 1) the standard for establishing a hedging relationship; 2) the method of effectiveness testing; 3) a requirement to rebalance hedge relationships; 4) restrictions on hedging certain risks or characteristics; 5) the inability to de-designate; and 6) the disclosure requirements.

In addition to the points listed above, we are concerned that the IASB proposal differs significantly from the FASB's Financial Instruments exposure draft (ED) issued in May 2010. We believe it is essential that any hedge accounting proposal reflect IASB and FASB convergence and we urge the IASB and FASB to work together to develop a converged hedge accounting standard.

1) The Standard for Establishing a Hedge Relationship

PNC strongly agrees that the current “highly effective” hedge accounting threshold creates a form over substance evaluation which often results in failed hedge accounting when a hedge program is adequately achieving its intended results. Therefore, we support moving from the current “highly effective” standard. However, PNC is concerned about the “unbiased result” and “other than accidental offsetting” criteria as proposed by the IASB as these terms do not reflect how entities view hedging relationships. Based on an entity’s risk management strategy, the purpose of a hedge relationship is to achieve a biased result and a purposeful offsetting of risk. For example, an entity may have a bias towards hedging expected movements in interest rates and, as a result, enters into a hedge of interest rate exposure. Entities may also elect not to hedge 100 percent of a risk due to cost or because natural offsetting of the risk occurs due to the composition of the entity’s balance sheet.

We do not believe the terms “unbiased result” and “other than accidental offsetting” adequately define how entities’ think about and manage hedging relationships. We recommend “reasonably effective”, as presented in the FASB’s Financial Instruments ED, be adopted as the hedge effectiveness criterion in the converged hedge accounting standard. We believe “reasonably effective” better describes that hedge relationships are a purposeful and, sometimes, biased attempt to hedge a risk(s) and is a term which is more familiar and understandable to financial statement preparers.

2) Hedge Effectiveness Testing

We further believe that qualitative effectiveness testing is more consistent with the approach of aligning hedge accounting to risk management strategies as it allows hedge relationships to remain effective except when the relationship no longer reflects an entity’s risk management strategy and/or when there are changes in the hedge relationship which call into question the effectiveness of that relationship. However, we interpret paragraph B34 (below) of the IASB’s exposure draft as a proposed requirement for quantitative testing except in circumstances where all critical terms match.

“For example, when the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedging relationship will probably achieve systematic offset and that the hedge ineffectiveness, if any, would not be expected to produce a biased result. This qualitative assessment might also allow the entity to determine an appropriate hedge ratio (e.g. 1:1 or as determined by simple ratio calculation) and also support an expectation that that hedge ratio would minimize any hedge ineffectiveness.”

As discussed above, we support the FASB's proposed reasonably effective hedge criterion and believe that qualitative effectiveness testing is consistent with that threshold. We do not understand how an entity would quantitatively test the effectiveness of a hedge under the IASB proposed "other than accidental offsetting" threshold which presumably is a more relaxed effectiveness criterion than reasonably effective. We strongly support qualitative effectiveness testing and would recommend quantitative effectiveness testing be used only when needed, for example, if a hedging instrument has been modified such that it cannot be determined on a qualitative basis if the hedge is still effective.

3) Rebalancing Hedge Relationships

We also interpret paragraph B34 of the IASB's exposure draft to require re-balancing of a hedge when the hedge ratio does not equal the ratio established at the inception of a relationship. We believe this approach may require more rebalancing than under current hedge accounting standards resulting in a more onerous standard. Again, the proposed approach is inconsistent with the principle that hedge relationships mirror risk management strategies because management's risk management strategy does not require rebalancing to a precise ratio. Further, potential continuous re-balancing is costly and results in the increased burden of adding or subtracting hedge instruments to maintain the hedge ratio. We do not support a requirement to re-balance a portfolio to meet a specific hedge ratio but do support the ability to voluntarily re-balance a hedge relationship when an entity determines that re-balancing will more effectively manage risk.

4) Restrictions on Hedging

Paragraphs IN46 and IN47 of the IASB's exposure draft indicate that an entity cannot hedge financial instruments using credit derivatives because it is "operationally difficult (if not impossible) to isolate and measure the credit risk component of a financial item as a component that meets eligibility criteria for hedged items." This point is contrary to recent discussions and the exposure drafts issued on the measurement of impairment where the Boards have stated that entities should isolate and measure credit losses associated with financial instruments. PNC recommends that the final standard allow entities to hedge any risk, including credit, provided that risk can be separately identified and measured.

Additionally, many entities bifurcate risk when establishing a hedge relationship as this technique allows entities the flexibility to align hedging with risk management strategies. In particular, entities engaged in mortgage banking often hedge mortgage servicing rights, mortgage-backed securities or portfolios of loans by hedging future changes in fair value of those instruments based on changes in interest rate movements. These hedge accounting practices are consistent with the IASB's stated goal of aligning hedge accounting more closely with risk management.

Because the notional of mortgage servicing rights, securities and/or loans is not precisely predictable, entities typically hedge these assets by designating a portion of the asset as the hedged item. We believe this technique is described in paragraph IN20 of the IASB's exposure draft as the layering approach and note that the IASB exposure draft prohibits a layering approach when the asset includes a prepayment option. Paragraph IN20 of the IASB exposure draft states: "The exposure draft proposes that a layer component of the nominal amount of an item should be eligible for designation as a hedged item. However, a layer component of a contract that includes a prepayment option is not eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk."

We believe it is essential that preparers have the ability to hedge mortgage servicing rights, securities, and loans using the layering technique. Therefore, we recommend that any proposed hedge accounting standard allow the hedge of a layer when the hedged item includes a prepayment option.

5) Inability to Voluntarily De-designate a Hedge Relationship

Consistent with the tenet that hedge accounting should align more closely with risk management strategies, PNC believes it is important that entities have the ability to voluntarily de-designate hedge accounting relationships as this permits revising hedge accounting when risk management strategies change. The ability to de-designate is particularly important for dynamic hedge relationships which are often used to hedge portfolios of loans. The changing composition of a loan portfolio often requires that hedges be rebalanced to maximize the benefit of hedging. Rebalancing may occur as frequently as daily and an entire or a portion of a derivative or a group of derivative instruments may be designated as the hedge of a portfolio of loans.

Paragraph IN7 of the IASB's exposure draft states the Board decided not to address open portfolios or macro hedging in the exposure draft; however, dynamic hedging is a technique often used by financial service entities. We recommend that any proposed hedge accounting standard address dynamic hedging and give entities the ability to de-designate and re-designate a hedging relationship.

6) Disclosure Requirements

The IASB exposure draft proposes that adjustments to a hedged items fair value as a result of hedge accounting should be disclosed separately from the hedged item under the premise that such separate presentation enhances the usefulness of financial statements. However, the adjustment to fair value does not represent an asset or liability; therefore, we believe it is not useful information and does not meet the criteria for separate disclosure within the financial statements. We believe financial statement users are interested in understanding the fair value of hedged items and therefore, would be interested in disclosure of that total fair value.

Below are our responses to the FASB's questions regarding the IASB's exposure draft on hedge accounting.

Responses to FASB's Specific Questions

Question 1: When an entity uses financial instruments to manage risk exposures in economic hedges but those instruments are not designated in hedging relationships for accounting purposes, do you believe that the proposed guidance would provide useful information about all of the effects of an entity's risk management objectives?

Response: The IASB's exposure draft specifically addresses hedge accounting and does not discuss economic hedges. In this regard, we view the proposal to be no different from current U.S. GAAP. As a result, we believe the exposure draft covers a narrow scope of an entity's risk management practices and would provide disclosure only on hedge accounting practices.

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?

Response: We believe the principles presented in the proposed guidance are sufficient to understand the meaning of risk management as well as how to apply that concept to individual transactions.

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?

Response: We do not foresee any changes in risk management objectives as a result of the proposed guidance. We believe the objective of any accounting standard should be reflect an entity's practices, such as risk management objectives, not to drive changes in those practices.

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?

Response: We do not believe risk management objectives are generally measurable and, therefore, could not be audited via a quantitative method. We are unsure whether a discussion of risk management objectives achieved through hedge accounting practices would result in a concern that auditors are opining on an entity's risk management objectives.

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?

Response: We agree that cash instruments should be eligible to be designated as hedging instruments and do not believe the ability to designate a cash instrument as a hedging instrument would cause concerns regarding circumventing classification and measurement requirements. We do not foresee operational issues with the designation of cash instruments as hedging instruments.

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?

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.

Response: We believe the principles presented in the proposed guidance are sufficient to understand constraints that must be applied in assessing the ability to hedge an item or a component thereof. In addition, we agree with the principles of separately identifiable and measurable as the criteria by which to determine the ability to hedge. As discussed in our general comments above, we disagree with several constraints presented in the proposed guidance including the inability to hedge credit risk and the inability to hedge a component (i.e. layer) of an item when that potential hedged item includes a prepayment option.

Question 8: Do you believe that “separately identifiable” should be limited to risk components that are contractually specified? Why or why not?

Response: We do not believe “separately identifiable” should be limited to contractually specified risk components.

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?

Response: We believe the existing guidance of paragraph 29(a)(2) of SFAS 133 should be included in any proposed hedge accounting standard as that guidance requires that a forecasted transaction be described with enough specificity so the forecasted transaction can be clearly identified when that transaction occurs.

Question 11: Do you foresee any operational concerns applying other guidance in IFRS (for example, guidance on impairment, income recognition, or derecognition) to those aggregated positions being hedged? For example, do you foresee any operational concerns arising when an impairment of individual items within a group being hedged occurs? If yes, what concerns do you foresee and how would you alleviate them?

Response: We do not foresee operational concerns with applying other IFRS guidance to hedged positions.

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?

Response: We do not believe the proposed guidance will enhance the reporting of derivatives as there is significant overlap with existing U.S. GAAP disclosure requirements with regard to derivatives and hedging. Therefore, we recommend existing disclosure requirements for derivatives and hedging should be carried forward to any proposed hedge accounting standard.

Question 13: Do you believe that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance and satisfy the proposed hedge effectiveness criteria? Why or why not?

Response: We agree that entities should be permitted to apply hedge accounting to a group or portion of cash instruments and do not foresee any operational concerns with this type of transaction. As discussed in our responses above, we believe if a risk is separately identifiable and measurable, it should be eligible for hedge accounting.

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?

Response: As stated in our general comments above we believe the threshold for assessing a hedge relationship should be reasonably effective rather than other-than-accidental offsetting. We do not foresee operational or audit issues related to applying a reasonably effective threshold.

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 value of the hedged item attributable to the related hedged risk for nonfinancial items)? If not, what additional guidance is needed?

Response: As stated in our general comments above, we believe hedge effectiveness should be assessed via a qualitative approach whenever possible and a quantitative approach should be used only when needed. We believe the IASB exposure draft implies that a quantitative approach must be applied in most circumstances and we disagree with this approach.

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?

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?

Response: As stated in our general comments above, our interpretation of the IASB's proposed guidance is that rebalancing of a hedge relationship would be required when the hedge ratio for a hedge relationship is no longer achieved. We believe this is a more onerous requirement than the current highly effective criteria and disagree with this approach.

Question 18: Do you believe that capitalizing the time value of an option as a basis adjustment of nonfinancial items (in other words, marking the asset or liability away from market) will improve the information that is provided in an entity's statement of financial position? Why or why not?

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?

Response: We do not believe adjusting a nonfinancial item's basis for the time value of an option used to hedge provides enhanced disclosure. Likewise, we do not believe presenting gains and losses in other comprehensive income provides enhanced disclosure.

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?

Question 21: Do you believe that there is sufficient guidance to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position with respect to presenting a separate line item in the statement of financial position?

Response: We do not agree with presenting the hedge adjustment for a hedged item as a separate line item in the financial statements as we believe the adjustment does not meet the criteria to be classified as an asset or liability. In addition, we believe for many entities hedge adjustments would be of an immaterial amount and, therefore, would not be separately disclosed on that basis.

Question 22: Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?

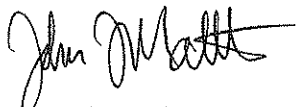
Response: We believe under current reporting requirements, risk management objectives are adequately discussed in the Management Discussion and Analysis section of a public entity's financial statements. Therefore, we do not believe it is necessary to include additional discussion of risk management objectives within the financial statement footnotes. Furthermore, as discussed in our response to Question 1 (above), the IASB proposed disclosure requirements would only apply to hedge accounting relationships.

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?

Response: We agree that hedge accounting should be aligned with risk management objectives; but we disagree with several of the proposed hedge accounting standards as discussed in our general comments above. We support the reasonably effective criteria as well as the qualitative effectiveness testing proposed by the FASB in its May 2010 Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*. We recommend convergence towards the FASB's proposal and the modifications we proposed in our comment letter response to that Proposed Accounting Standards Update.

We appreciate the FASB's request for feedback on this matter and appreciate the opportunity to share our views with the Board and staff. We welcome any questions or comments you may have. Please contact me with any questions about PNC's comments at 412-762-7546.

Sincerely,



John (JJ) Matthews
Director of Accounting Policy
The PNC Financial Services Group, Inc.

cc: Mr. Richard Johnson
Executive Vice President and Chief Financial Officer
The PNC Financial Services Group, Inc.

Mr. Gregory Kozich
Senior Vice President and Controller
The PNC Financial Services Group, Inc.