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November 4, 2016

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

By email: director@fasb.org

Re: File Reference Number 2016-310, Exposure Draft, *Derivatives and Hedging (Topic 815) – Targeted Improvements to Accounting for Hedging Activities*

Dear Ms. Cosper,

Chatham Financial ("Chatham") is pleased to comment on the Financial Accounting Standards Board's ("FASB" or "Board") Proposed Accounting Standards Update, *Derivatives and Hedging* (the "Exposure Draft" or "proposal"). Chatham serves as a hedging advisor to over 1,800 companies globally in many different industries. More than 500 of our clients apply the hedge accounting provisions of either Accounting Standards Codification ("ASC") 815, International Accounting Standards ("IAS") 39 or International Financial Reporting Standards ("IFRS") 9. We assist these companies with the application of hedge accounting on thousands of derivative transactions, which includes preparing hedge designation memos, effectiveness testing, derivative valuations, journal entries and disclosures for a variety of hedging relationships in many different industries. Given our role, we understand the impact of the proposed guidance on a broad spectrum of derivative end users. We share the following comments from that perspective.

We support the FASB's stated objective to develop accounting guidance that better portrays the economic result of an entity's risk management activities and simplifies certain aspects of the hedging standard.

Specifically, we agree with the following proposed changes:

1) **Risk component hedging**. The ability to designate a contractually specified risk component for both financial and nonfinancial items is a significant change that we believe will benefit many companies. This proposed change will simplify hedge accounting for common strategies such as cash flow hedges of prime-based loans and will make certain types of hedges of nonfinancial risk operational.
2) **Refining fair value hedging**. We agree with the FASB's decision to refine fair value hedging by permitting partial term and component hedging. These two changes represent significant improvements to the fair value model and largely achieve the Board's primary objective.
3) **Simplifications to hedge accounting.** We agree with the changes the FASB made to simplify and reduce the administrative burden of applying the standard. In particular, qualitative assessments of effectiveness and permitting the "critical terms match" approach when a forecasted transaction occurs and a derivative settles within the same 31-day period are very helpful improvements.

We believe that by making the following additional changes, the Board would further meet its stated objectives.

Further refinement of fair value hedging. We believe the FASB should permit entities to designate layers of fair value hedges. This change would further refine the fair value model to better align with the economics of certain hedging strategies. Today's requirement that entities may designate only a proportion of the hedged item causes unnecessary complexities with these hedging relationships if even a slight pay down occurs. We believe that the layer designated should have the same risk characteristics of the whole instrument. For example, an entity should be permitted to hedge the first $80 million of $100 million of callable debt, but not be permitted to exclude the call feature by hedging only a hypothetical "non-callable" layer (assuming the entire instrument is callable).

Critical Terms Match ("CTM") criteria. We believe the FASB should permit an entity to meet requirements of the "critical terms match" approach when a forecasted transaction occurs and a derivative settles within the same *fiscal month* rather than just the 31-day period in the current proposal. Certain entities, such as retailers that operate under the "4-5-4" fiscal calendar convention, have a 35-day fiscal month one out of every three months. Consequently, those entities would not be able to apply CTM under the proposed guidance for those periods (and in fact may not be able to apply CTM at all since they would still be required to assess effectiveness similarly for similar hedging relationships).

Revision to Derivatives Implementation Group ("DIG") Issue G23. While we recognize the FASB's decision to address only a limited number of topics related to foreign exchange hedging, we believe the Board should remove the guidance in ASC 815-20-25-41 and ASC 815-20-55-141 through 55-155 (formerly DIG G23). We have observed significant differences in how entities apply this guidance related to hedging specified cash flows of a foreign-currency denominated interest-bearing financial instrument. Specifically, we believe there is a misalignment of the timing of OCI release and the effect of the hedged transaction on the financial statements. As a result, we have observed diversity in practice for entities that apply hedge accounting for similar hedging relationships. Moreover, we observed cases where entities ignore the guidance altogether. We have included additional detail at the end of the letter related to the inconsistencies and complexities this guidance causes.

Component hedging vs. separately identifiable and reliably measurable. We believe the Board should implement a "separately identifiable and reliably measurable" concept for designating hedged risks. We believe component hedging is the key to better aligning hedge accounting with the economics of risk management activities. The separately identifiable and reliably measurable concept would provide a single principle for entities to select the hedged risk, instead of requiring them to apply the two concepts in the proposed update – one for cash flow hedges of financial and nonfinancial risk and another for fair value hedges of financial risk. This concept would simplify the standard, allow it to adapt to changes in the marketplace, is consistent with common risk management practices, and would converge with international accounting standards.

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We thank the Board for its consideration of our comments and would be pleased to discuss these issues in more detail with the Board or staff at your convenience. Please do not hesitate to contact me at (484) 731-0233 or at scastleton@chathamfinancial.com.

Sincerely,

Steve Castleton
Managing Director, Global Accounting Advisory
Chatham Financial

Answers to Questions for Respondents

1. The Board decided it would allow an entity to designate the hedged risk as the variability in cash flows attributable to changes in a contractually specified component stated in the contract in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset. Do you agree with that decision? Please explain why or why not. If not, what specific alternatives should the Board consider? Please explain why those alternatives would be beneficial.

Yes, we agree. We believe this decision is one of the most significant improvements over the current guidance because it aligns the economics of risk management strategies with the reported accounting results. The requirements of the current guidance prevent bifurcating nonfinancial hedged risks, making commodity hedging difficult (and in some cases inoperable). As a result, an entity seeking to hedge a commodity exposure must include changes in fair value or cash flows due to all changes in cash flows – which includes basis and other factors it has no intention of hedging and for which likely no traded derivatives exist. We have observed that some entities elect not to apply hedge accounting involving certain hedges of nonfinancial risk even for common risk exposures that are simple to hedge economically. Unfortunately, in some cases, entities decide not to hedge at all because hedge accounting cannot be applied.

2. The Board decided that it would retain the concept of benchmark interest rates for hedges of fixed-rate financial instruments and forecasted issuances or purchases of fixed-rate financial instruments, maintain the existing list of permissible benchmark rates, and add the SIFMA Municipal Swap Rate to the list.

2a. Should the Board retain the current concept of benchmark interest rates for fair value hedges of fixed-rate financial instruments and for cash flow hedges of forecasted issuances or purchases of fixed-rate financial instruments? Please explain why or why not.

Yes. In the absence of a "separately identifiable and reliably measurable" standard, we believe the Board should retain the benchmark concept because it is the most logical way to identify the hedged risk in a fixed-rate financial instrument. With the addition of SIFMA, we believe the current definition includes the benchmark rates most commonly hedged in practice.

2b. If the Board continues to maintain the current concept of benchmark interest rates, should the Board consider within the concept expectations that a rate will become widely used?

Yes. However, whether an interest rate is widely used should not be the only factor for determining whether it should be considered a benchmark rate. When the Board added OIS, we thought that process worked very well. Usage was certainly a factor, but the Board also focused on the qualities of OIS in deciding that it should be a benchmark rate. Currently, regulators and private market participants are working to create additional benchmark interest rates that could eventually replace US dollar LIBOR as the primary reference rate. We believe it would be helpful for the Board to add the new interest rates if the market accepted and began using those new interest rates, even if usage was not initially high.

2c. If the Board continues to maintain a list of rates, are there any other rates that should be added to the list? Please explain why a particular rate meets the definition of a benchmark rate.

We would not add additional rates at this time.

2d. Are there other alternatives to the current concept of benchmark interest rates the Board should consider (for example, a principles-based approach)? Please describe those alternatives.

As stated above, we believe that the separately identifiable and reliably measurable concept is more flexible and better aligns the accounting results with the economic risks. Further, we believe the Board could draft the concept to prevent abuse.

3. The Board decided that it would allow an entity to use either the full contractual coupon cash flows or the cash flows associated with the benchmark rate determined at hedge inception in calculating the change in the fair value of the hedged item attributable to interest rate risk, except when the current market yield of the financial instrument is below the benchmark rate at hedge inception. In that instance, the total contractual coupon cash flows would have to be used. Do you agree with this decision? Please explain why or why not.

We agree with the Board's decision to allow an entity to use either the full contractual coupon cash flows or the cash flows associated with the benchmark rate determined at hedge inception in calculating the change in the fair value of the hedged item attributable to interest rate risk. The requirement to use the entire contractual cash flow can lead to significant ineffectiveness due to the credit spread component of the contractual interest rate.

While we generally agree with this decision, we do not understand why the Board would prevent hedging a benchmark rate when the current market yield of the financial instrument is below the benchmark rate at hedge inception. This prohibition is an unnecessary change from current guidance that widens the gap between risk management practices and hedge accounting. We recommend the Board permit hedge accounting whether the market yield is above or below the benchmark rate at hedge inception.

For example, consider the following two scenarios:

- If an entity were to hedge a 2% fixed-rate bond when the benchmark interest rate is 1.50%, the swap would receive fixed at 2% and pay LIBOR + 0.50%.
- If an entity were to hedge a 1% fixed-rate debt when the benchmark interest rate is 1.50%, the swap would receive fixed at 1% and pay LIBOR - 0.50%.

Each hedge is effective because the two derivatives are based on a swap rate of 1.50% and changes in the fair value of the hedged item are calculated based on the exact same *changes* in the benchmark rate, whether it moves up or down. Changes in interest rate risk affect financial instruments whose yields are above or below the then-current market yield very similarly. While there may be small differences in convexity of a 1% and 2% debt instrument, both hedges would be highly effective. Both hedges are economically perfect at synthetically converting the cash flows of the bond from fixed to floating.

4. In regard to hedging forecasted transactions, paragraph 815-30-40-5, as amended, states that "a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions." What is your policy on what constitutes a pattern? Are there certain instances or scenarios in which missed forecasts should not be incorporated into the consideration of this pattern?

We do not have a specific policy. We generally work with our clients and their auditors to evaluate the facts and circumstances of the missed forecast to determine whether it constitutes a pattern. We have observed diversity in practice surrounding missed forecasted transactions. Generally, entities have not been penalized if there is a supportable business case or an economic event that is difficult to forecast (e.g., the Brexit vote and the financial crisis).

In general, we prefer not to have bright line, numeric rules around this concept. We believe the *probable* standard for hedging a forecasted transaction allows for some uncertainty. Although probable is a high threshold, we believe there should be some flexibility for an entity to miss a forecasted transaction without a penalty. Perhaps the entity should disclose why it missed its forecast and when it last missed a forecasted transaction. We believe these steps would prevent entities from cherry picking gains and losses while allowing for reasonable misses in forecasted transactions.

5. Are there hedging relationships that would be eligible to meet the requirements in the proposed amendments and IFRS 9, but the hedge results would be recognized and presented differently? If so, please describe the transaction and why it would be recognized and presented differently in accordance with IFRS 9.

A number of recognition and presentation differences will exist for hedging relationships that would meet the requirements in the proposed amendments and IFRS 9. The following list describes some of those differences:

- For qualifying hedging relationships, IFRS 9 continues to require hedge ineffectiveness to be separately measured and recognized in the financial statements, whereas the FASB's proposal would no longer require hedge ineffectiveness to be separately measured and recognized in the financial statements;
- CVA/DVA for cash flow hedges under IFRS will be recorded in earnings as ineffectiveness;
- Treatment of costs of hedging (i.e., forward points, time value, and currency basis) is different between the two standards;
- The approach to assessing whether a hedging relationship is effective at offsetting the risk being hedged (i.e., performing effectiveness assessments) is also different;
- IFRS 9 does not require presentation of an excluded component in the same line item as the earnings effect of the hedged item.

6. Do you agree with the following Board decisions on presentation? Please explain why or why not. If not, what other alternatives should the Board consider?

6a. For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would modify current GAAP by requiring the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is presented.

While we prefer the flexibility in the current guidance, we believe the Board's decision is operational and will work in practice. However, we believe this change could make financial statements more confusing or even misleading in certain circumstances. For example, when large CVAs create ineffectiveness in fair value hedging relationships, interest expense may go negative.

6b. For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would retain current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be recorded currently in earnings. For qualifying fair value and cash flow hedges, the proposed amendments would modify current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is (or will be) presented. For qualifying net investment hedges, there will be no prescribed presentation requirements for changes in the fair value of the hedging instrument excluded from the assessment of effectiveness.

We agree with the Board's decision to continue to permit entities to exclude certain components from the assessment of effectiveness. The ability to exclude certain components is an important feature that some companies use in their hedging programs to make those programs operationally feasible. For example, it is common for entities to exclude forward points from their effectiveness assessments when they hedge percentage of completion contracts denominated in a foreign currency. This ability to exclude forward points greatly simplifies the reclassification into earnings of amounts deferred in OCI.

While we support the proposed changes, we believe that the Board should permit flexibility for entities to decide where to recognize excluded components for cash flow and fair value hedges, similar to net investment hedges. We believe management should be able to determine where to recognize the excluded component, just as it determines where to recognize the gain or loss on a non-designated derivative.

6c. For cash flow hedges in which the hedged forecasted transaction is probable of not occurring, the proposed amendments would retain current GAAP by requiring amounts recorded in accumulated other comprehensive income to be reclassified to earnings immediately. However, the proposed amendments would require presentation of reclassified amounts in the same income statement line item in which the earnings effect of the hedged item would have been presented had the hedged forecasted transaction occurred.

Similar to our prior two responses, we believe the Board should permit flexibility in where to recognize the amounts reclassified from OCI. For many companies, a frequent cause of hedged forecasted transactions becoming probable of not occurring is related to the decision to sell assets financed with hedged debt. As a result, there is typically a gain or loss on the sale of the asset and the prepayment of the outstanding loan. In these cases, we believe it would be more appropriate to recognize the amounts reclassified from OCI into earnings in the same financial statement line item as the gain or loss on the sale of the asset.

In addition, we believe this Board decision could have unintended consequences. For example, if an entity terminated debt or if a forecasted debt issuance did not occur and the hedging derivative was in a gain position, the entity likely would recognize negative interest expense. Further, we believe that significant volatility in key line items could have unintended adverse effects on debt covenants.

7. Do you agree with the proposed disclosure amendments in (a), (b), and (c) below? Please explain why or why not.

7a. Cumulative basis adjustments related to fair value hedges

Yes, we agree with the Board's proposal.

7b. Quantitative hedge accounting goals, if any, that an entity sets when developing its hedge accounting objectives and strategies and whether it met those goals

For large or complex global entities, this disclosure could become quite burdensome. However, our primary concern with this proposed amendment is the potential disclosure of information about an entity's risk management practices that may be deemed to be proprietary or confidential.

7c. Revised tabular disclosure for fair value and cash flow hedges that would focus on the effect of hedge accounting on income statement line items.

We agree with this change and believe it will be helpful for users of financial statements. Amending this disclosure to focus on the effects of hedge accounting on specific income statement line items will provide more useful information to users of financial statements without a dramatic increase in the time and cost required to prepare those disclosures.

8. Unless the hedging relationship meets one of the exceptions that assumes perfect offset at hedge inception, an entity would be required to perform an initial quantitative test of hedge effectiveness and would be allowed to perform subsequent hedge effectiveness assessments qualitatively unless facts and circumstances change. Do you agree with this proposed change? Please explain why or why not.

Yes, we agree with the proposed change. Many hedging relationships are highly effective, but they do not meet the strict requirements to make an assumption of perfect offset. For these highly effective hedging relationships, we believe hedge accounting should be simplified. Preparers will appreciate the reduction in the administrative burden related to common, simple hedging strategies that have little or no mismatches.

9. The Board decided that an entity may elect at hedge inception to perform subsequent assessments of effectiveness qualitatively. However, certain changes in the facts and circumstances associated with the hedging relationship in subsequent periods may require a quantitative assessment of effectiveness to be performed. Once an entity determines that a quantitative assessment of effectiveness is required, the entity would be prohibited to return to qualitative testing in periods after this determination is made. Can situations arise in which an entity no longer may assert qualitatively that the hedging relationship continues to be highly effective but when tested quantitatively would be highly effective? If so, please describe those circumstances. Should an entity be allowed to return to qualitative testing after such a significant change in facts and circumstances precluded it in a prior period? If so, please discuss the factors that an entity should consider to justify a reasonable expectation that the hedge will once again be highly effective on a qualitative basis.

We agree with the Board's decision that an entity should not be allowed to return to qualitative testing after a determination has been made that quantitative testing is necessary. Situations can arise in which an entity no longer may assert qualitatively that the hedging relationship continues to be highly effective, but when tested quantitatively, the test could be highly effective. If the mismatch persists, we believe it is appropriate to require continued quantitative effectiveness testing. In those cases, circumstances may arise where a mismatch is determined to be minimal on one testing date, but at a later testing date is determined to be significant. We believe it would be inappropriate for an entity to ignore these mismatches based on a single quantitative test. This could lead to the incorrect conclusion that a hedging relationship is highly effective based on a qualitative assessment at a later date when, in fact, it is not.

For example, we have recently observed interest rate swaps where a zero percent floor existed in the debt instrument but was not included in the hedging instrument. Several years ago a zero percent floor included in the debt instrument had little value given the interest rate environment, and therefore had little impact on the quantitative assessment of effectiveness when modeled into the hypothetical derivative. However, due to changes in the level of interest rates, the zero percent floor may have significant value today and can cause a quantitative assessment to fall outside of the highly effective threshold, even when in prior periods it qualified as highly effective. If subsequent effectiveness assessments are not performed, an entity could inappropriately continue to apply hedge accounting in a hedging relationship that is no longer highly effective. We have observed many types of basis differences that exist in practice that could result in inappropriate or inaccurate conclusions if quantitative testing is not performed.

10. Do you agree with the proposed amendment that would allow an entity to perform the initial quantitative testing portion of hedge documentation at any time between hedge inception and the quarterly effectiveness testing date using data applicable as of the date of hedge inception? Please explain why or why not.

We believe that having additional time to complete the inception quantitative effectiveness assessments may be a helpful accommodation for some entities, although it creates an additional requirement for entities to have controls in place to ensure the testing is performed at a later date. We expect to continue to prepare this effectiveness assessment contemporaneously with the rest of the required hedge documentation at the inception of the hedging relationship. From our perspective, the incremental amount of work required to complete this inception effectiveness testing, when considered in the context of all the documentation requirements, is relatively minimal.

11. The proposed amendments related to the timing of the preparation of hedge documentation and subsequent qualitative testing apply to both public entities and private companies. Are there valid reasons why the content of or the timing of the preparation of hedge documentation should be different for public entities and private companies? If so, please describe the specific types of transactions for which different treatment should be considered.

We believe that the documentation requirements, including the timing of preparation, should not be different for public and private companies. This is due largely to the fact that the underlying reasons for requiring robust, contemporaneous documentation (i.e., to avoid abuse and the ability to cherry-pick gains and losses) are equally applicable whether an entity is public or private – and the temptation for abuse is present at both public and private entities.

12. Should the effective date be the same for both public business entities and entities other than public business entities?

Yes, we believe the effective date of the new guidance should be the same for both public business entities and other than public business entities.

13. How much time is needed to implement the proposed amendments? Should entities other than public business entities be provided more time? If so, how much more time?

We believe that one year should be sufficient to implement the proposed standard and that early adoption should be permitted. We do not see significant reason for entities that are not public to be given additional time to implement the proposed guidance. If anything, we believe other than public business entities will be more eager to adopt the proposed guidance given the simplifications available and the fact that those entities are often less capable of meeting the rigorous criteria required to apply hedge accounting.

14. Do you agree with the proposed transition method and disclosures in paragraph 815-20-65-3? Do you agree with the Board's decision not to allow a retrospective transition approach? Please explain why or why not.

Given the prior decisions made by the Board concerning retrospective adoption, we agree with the proposed transition method outlined in the exposure draft. We also would not be opposed to a full retrospective transition approach.

Additional information on suggested revisions to G23:

Revision to DIG G23. As we mentioned at the beginning of our comment letter, we believe the guidance in DIG G23, codified as ASC 815-20-25-41 and ASC 815-20-55-141 through 55-154, should be removed from ASC 815. The example in this guidance illustrates a common economic strategy of hedging the foreign currency risk associated with the repayment of principal of foreign-denominated debt. The hedged transaction affects earnings as the principal balance is remeasured to the respective spot rate each fiscal period. Such remeasurement is performed in accordance with the guidance in ASC 830, which is calculated based on the carrying value of the debt (the example illustrates this as the debt par value). However, the calculation of the amount to reclassify from OCI to offset these remeasurement gains and losses is based on a discounted value of the debt, which results in an OCI reclassification that is misaligned with the financial statement effect of the hedged transaction. That is, the remeasurement of the hedged transaction is based on its carrying value, but the OCI reclassification is based on a discounted value of the hedged transaction. This misalignment results in an amount being held in OCI related to the effect of discounting the principal balance of the debt before calculating the amount to reclassify from OCI. The amount held in OCI is recognized in future fiscal periods as the discounted principal value approaches the par value, which further exacerbates the misalignment in the statement of earnings.

We believe that if an entity elects to hedge only certain cash flows or a certain tenor of the life of its foreign-denominated asset or liability, that this should not result in a different and more complex cash flow hedging model than would otherwise be required. As a result, we believe that removing the guidance in DIG G23 would be directly in line with the Board's intent to better align accounting results with an entity's economic risk management practices while at the same time simplifying the guidance by eliminating a complex exception to the general cash flow hedge accounting guidance.