Chatham
FINANCIAL

June 28, 2021

Ms. Hillary Salo
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 No. 2021-002, Exposure Draft, *Derivatives and Hedging (Topic 815): Fair Value Hedging-Portfolio Layer Method*

Dear Ms. Salo,

Chatham Financial Corp. ("Chatham") is pleased to comment on the Financial Accounting Standards Board's ("FASB" or "Board") Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815): Fair Value Hedging-Portfolio Layer Method* (the "Exposure Draft" or "Proposal"). Chatham serves as a hedging advisor to more than 3,000 companies annually across the globe and in many industries. Chatham assists more than 600 companies with the application of the hedge accounting provisions of Accounting Standards Codification ("ASC") 815, International Accounting Standards ("IAS") 39, or International Financial Reporting Standards ("IFRS") 9. In addition, we have been assisting our financial institution clients with the application of the last of layer method since it was issued in 2017 and are currently advising them on how to apply the Proposed guidance, once issued. Chatham's involvement with clients often leads to discussing the application of the hedge accounting guidance with their audit teams and respective National office derivative experts. As a result, we believe we are well positioned to provide helpful feedback related to the Board's efforts to expand the Last of Layer Method ("LOL") into the Portfolio Layer Method ("PLM").

Overview

We are generally very supportive of the Proposal and are encouraged by the additions that will enable entities to execute a broader array of hedging strategies against pools of fixed rate financial assets (e.g., amortizing swaps and the ability to hedge multiple hedged layers within a closed pool). However, we believe some of the proposed requirements related to creating the closed pool of financial assets, creating hedged layers, and designating hedging relationships need to be clarified, are unnecessarily restrictive, and may lead to undesirable hedging activity. We believe these requirements need clarification in order to avoid additional cost or unintended accounting consequences. Please see our feedback and responses to the Questions for Respondents below.

Questions for Respondents

Question 1-Operability: Are the amendments in this proposed Update operable and auditable? If not, which proposed amendment or amendments pose operability or auditability issues and why?

Response: We generally find the proposed amendments to be operable and auditable. However, as we describe further below, we believe clarification is needed regarding the hedged item requirements in 815-20-25-12A(d) and (e) and how creation of the closed pool, creation of hedged layers, and execution of hedges are required/permitted to occur in relation to each other.

We are concerned that the criteria in 815-20-25-12A(d) and (e) may lead to diversity in practice and/or auditor interpretation as currently written. Specifically, 815-20-25-12A(e)(1) and (2) require all assets in the closed portfolio to be or become prepayable by the maturity date of the hedge (for hedges of a single layer) or the longest dated maturing hedge (for hedges of multiple layers). Further, 815-20-25-12A(d)(1) and (2) require all assets in the closed portfolio to mature after the maturity date of the hedge (for hedges of a single layer) or the earliest dated maturing hedge (for hedges of multiple layers). Our interpretation is that the Proposal requires all assets in the closed pool to both be prepayable before and mature after dates in hedge contracts that likely have not been executed yet, which seems out of sequence (unless redesignating existing hedging instruments). The requirements seem to imply that hedges have been executed before the closed pool was created, which we believe will not always be the case. Rather, we believe entities typically will first establish the closed pool of fixed rate financial assets, then create one or more hedged layers they desire to hedge, and subsequently execute hedges to designate against the hedged layers. We believe this is an important distinction because executing hedges before creating a closed pool and establishing layers could lead to an interpretation in practice or with auditors that the hedges need to be marked to market through earnings until the closed pool and hedged layers are created and a proper fair value hedge designation can be made. As a result, we believe additional clarity is needed within the Proposal regarding how creating a closed portfolio, creating hedged layers, and executing hedges need to be considered in relation to each other.

Presuming additional clarity is provided, we believe the proposed requirements in 815-20-25-12A(e)(1) and (2) are unnecessarily restrictive and may lead to undesirable hedging behavior. The requirements in these paragraphs may prevent an entity from executing a valid hedge for risk management purposes (e.g., if an entity desired to execute a hedge maturing in five years from today but all of the assets in the closed pool are not prepayable before then and all of assets in the closed pool do not mature after that date, it would be unable to execute that hedge). We are concerned this could lead to entities executing nominal notional amount “bookend” hedges simply to satisfy the criteria in these paragraphs and then execute their valid hedge for risk management purposes (e.g., execute a very short-dated nominal notional hedge and a very long-dated nominal notional hedge such that all of the assets in the pool mature after the maturity of the short-dated hedge and are prepayable before the maturity of the long-dated hedge). We believe this is not desirable behavior and it could be addressed by modifying 815-20-25-12A(e) to require only that the assets become prepayable during their contractual life to be included in the closed portfolio and by modifying 815-20-25-12A(d) to require only that the assets mature after the assumed maturity date of the hedged layer they are included within.

Similarly, it is unclear to us in 815-20-25-12A and 12B if there are restrictions regarding when hedged layers may be created. The proposed guidance seems to imply the hedged layer(s) is (are) created initially. This is further reinforced in the implementation guidance in 815-20-55-14C – H where the layers are created at the same time. We believe entities will desire to create new hedged layers within the closed pool in the future as part of their ongoing financial risk management activities. It is unclear if this is permitted in 815-20-25-12A and 12B. We believe it was the FASB’s intent to permit hedged layers to be added over time and believe these paragraphs should be clarified to avoid misinterpretation.

Separately, we observe that the proposed changes in 815-25-35-13B make it less clear as to how a forward starting hedged item should be valued, which we believe will be necessary for hedged layers created for future periods. The proposed deletion of “when the first hedged cash flow begins to accrue" in the first sentence is an important element of valuing a forward starting hedged item and we believe it should be incorporated into the Proposal to avoid confusion.

In addition, we anticipate situations where entities combine different asset classes from within the closed pool into a single hedged layer. It is unclear to us whether the analysis described in 815-20-25-12A(a) and (b) can be different for each asset class within the hedged layer. We believe it would be helpful to clarify the Board's intent regarding how the analysis should be performed when the hedged layer consists of multiple asset classes.

Question 2-Risk Management: As proposed, would the multiple-layer model align with entities' risk management objectives? Please explain why or why not?

Response: As mentioned in our response to question 1, we believe the Proposal is a positive step but believe the hedged item requirements should be clarified and made less restrictive. In addition, we appreciate that many entities are eager to apply the guidance in the Proposal and while we don't suggest delaying its release, we provide the following additional feedback that we believe would make the Proposal more in line with entities' financial risk management objectives. We believe these items could be considered later if the Board undertakes a Hedging 2.0 project:

1. The portfolio of assets could remain open rather than require it to be closed. For entities that seek to greatly expand the size of the portfolio of fixed rate assets to hedge, removing the closed portfolio criteria would permit additional assets to be added over time and would help to ensure that breaches of the non-prepayable layer(s) are unlikely to occur. Given that the objective is to identify a layer or layers that are not expected to be breached by prepayment, enabling entities to add prepayable assets to the pool over time would help secure this objective and facilitate prudent financial risk management.

2. The requirement for an asset to be prepayable to be included in the closed portfolio could be removed entirely. The focus of the PLM is to create hedged layers that are not expected to be prepaid. Permitting the inclusion of non-prepayable fixed rate assets into the closed pool would serve to reduce the likelihood that hedgers would encounter situations where either anticipated or actual breaches occur.

3. We believe the Proposal could be extended to prepayable financial liabilities without significant additional cost or risk of unintended accounting consequences. We assist numerous financial institutions with their balance sheet risk management hedge accounting, including community and regional banks, government agencies, and large insurance/re-insurance companies. These entities often have significant pools of prepayable financial liabilities that are challenging to hedge under the current fair value hedge accounting model. Primary examples include brokered certificates of deposits that can be called by the issuer or prepaid upon the death of the CD holder and insurance liabilities that can be terminated upon lapse or death of the policy holder. These liabilities create interest rate risk for the financial institution that would be easier to hedge if the PLM supported hedging a pool of liabilities. Furthermore, insurance liabilities are extremely long-dated—with many instruments extending up to 50 years—and insurers are generally unable to apply hedge accounting to the derivatives executed to manage this significant interest rate risk without significant investment in systems to employ a dynamic hedging program with frequent dedesignations and redesignations. Entities could apply similar approaches to create and monitor hedged layers of their prepayable fixed rate financial liabilities as would be required for prepayable assets. Entities interested in hedging more of their financial risk would have additional strategies to

consider, which would better support their financial risk management activities. Also, this recommendation would not result in additional cost for entities that don't apply the model to prepayable fixed rate financial liabilities.

Question 3-Scope: Do you agree with the Board's decision to limit the scope of the types of instruments eligible for portfolio layer method hedging to prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments? Please explain why or why not.

Response: We do not agree. Please see our response to question 2, which indicates our views on additional financial instruments that could be included within the scope of the PML.

Question 4-Dedesignation Sequencing: Do you agree with the Board's proposed amendments on hedge designation sequencing under the multiple layer model? Please explain why or why not.

Response: We believe the ability to use discretion afforded for anticipated breaches in 815-25-40-8(a) could be extended to actual breaches in 815-25-40-8(b)(2). We believe this could be accomplished by permitting entities to develop a policy for how dedesignation upon actual breach would be treated, with failure to specify a policy resulting in application of the currently Proposed guidance.

Question 5-Basis Adjustments: Do you agree with the Board's proposed amendments on accounting for basis adjustments and disclosure of those basis adjustments in disclosures required by other areas of GAAP outside hedge accounting? Please explain why or why not.

Response: We believe the proposed amendments are appropriate.

Question 6-"Follow the Asset" Method: In the case of a breach, do the expected costs of identifying which assets in the closed portfolio that caused the breach justify the expected benefits of aligning the derecognition guidance with other Topics in GAAP? Please explain why or why not.

Response: We believe the proposed amendments in 815-25-40-9A(a) may present challenges to implement for some entities. It may be challenging to timely identify assets that caused an actual breach. We believe it could be sufficient to make a policy election for where to record such gains and losses on the income statement and disclose such amounts, if material.

Question 7-Certain Private Companies and Not-for-Profit Entities: Would any of the proposed amendments require special consideration for private companies that are not financial institutions and not-for-profit entities (except for not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market)? If so, which proposed amendment or amendments would require special consideration and why?

Response: No, we are not aware of any proposed amendments that require special consideration for private companies that are not financial institutions and not-for-profit entities.

Question 8-Transition: Do you agree with the proposed transition guidance? Please explain why or why not.

Response: We believe the proposed amendments could be early adopted upon issuance of a final Update. Otherwise, we believe the transition guidance is sufficient.

Question 9-Implementation: How much time would be needed to implement the proposed amendments? Should the amount of time needed to implement the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities? Please explain your response.

Response: Many entities we work with have been applying the Last of Layer method for several years. We do not believe that the Portfolio Layer method presents significant additional complexities that will take extensive amount of time to implement. Further, the Proposal is optional and entities can choose when to make additional investments at their discretion based on its importance to their organization.

Closing

We thank the Board for its consideration of our comments and would be pleased to discuss these issues in more detail with either the Board or Staff. Please do not hesitate to contact me at (484) 731-0228 or at dgentzel@chathamfinancial.com.

Sincerely,

Dan Gentzel
Managing Director, Global Hedge Accounting
Chatham Financial Corp.