Chatham
FINANCIAL

September 21, 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. 2021-004, Agenda Consultation

Dear Ms. Salo,

Chatham Financial Corp. ("Chatham") is pleased to provide feedback about the future standard-setting agenda of the Financial Accounting Standards Board (FASB). Chatham serves as a hedging advisor to more than 3,000 companies annually across the globe and in many industries. Chatham assists more than 700 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. Chatham's involvement with clients includes assisting them with the accounting and financial reporting and disclosure of their hedging activities. Our assistance 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 set its standard-setting agenda.

Given our background and experience in the derivatives and hedging space, our feedback on the FASB's agenda primarily relates to hedge accounting and Topics 815 and 848. As mentioned in Appendix A of the Agenda Consultation, there are several existing projects related to hedge accounting, which we believe should be completed. In addition, given changes in the markets due to the evolution of sustainable finance as well as the impact of the Covid-19 pandemic, questions have arisen in practice regarding whether the definition of a derivative and related scope exceptions should be revisited. We provide additional feedback below regarding these items.

Emerging Areas in Financial Reporting – Definition of a Derivative

Agenda Consultation Question 9: What challenges, if any, are there in applying the guidance on the definition of a derivative and the related derivative scope exceptions in Subtopic 815-10? Please explain the challenges and whether and how they could be addressed through standard setting.

We are aware of several areas where the definition of a derivative and its related guidance may not address recent market developments and could likely be addressed via targeted improvements rather than an overhaul of the existing guidance.

There has been considerable growth in the Sustainable finance space over the past few years, which is expected to continue. Many sustainable bonds and debt instruments include features tied to achieving Corporate sustainability measures that if satisfied will result in a reduction in interest paid by the issuer. Many of these features may be considered embedded derivatives under the existing guidance in Topic 815, and as a result, may need to be bifurcated and accounted for separately. The existing scope exceptions in Topic 815 were written many years ago and did not contemplate sustainable finance. Issuers of these instruments may need to spend resources to develop processes for identifying and measuring ESG features. We understand the impact on the financial statements from such ESG features is often not material. As a result, we believe it is necessary to reevaluate the scope exceptions in Topic 815 to determine if exceptions should be added to address common types of embedded ESG features.

We have also recently observed situations where ESG features have been considered for inclusion in derivative instruments, like cross currency interest rate swaps. Despite the immaterial nature of the ESG feature, auditor interpretation in practice has been that the inclusion of such feature would prohibit the cross currency interest rate swap from being designated in a net investment hedge, whereas absent the ESG feature the derivative would be permitted to be designated in a net investment hedging relationship. We do not believe this type of interpretation is a desirable outcome and believe it is another reason that ESG features need further attention regarding their proper treatment from an accounting perspective.

In addition, the onset of the Covid 19 pandemic in early 2020 led to a sharp, fast decline in US interest rates. Many entities that were party to pay fixed rate / receive variable rate interest rate swaps witnessed the fair value of those instruments become significant liabilities and sought to modify the interest rate swap to both “extend” the term and “blend” the liability into a new pay fixed rate (referred to as an extend and blend transaction). Typically, in extend and blend transactions no cash is paid by either party, the counterparty remains the same, the pay fixed rate is lowered, and the instrument’s term is extended to provide the entity with more time to repay the liability. There is essentially no or minimal change in fair value of the instrument as a result of these changes.

The increase in frequency and magnitude of these transactions due to market conditions led to debate in practice as to whether the instrument needs to be reevaluated when the extend and blend occurs to determine if it is a derivative in its entirety per ASC 815-10-15-97 (as further described in the examples in ASC 815-10-55-148 through 168). It is unclear if the analysis described in ASC 815-10-55-148 through 168 is intended to be applied to derivative modifications rather than only to newly issued derivatives. In addition, the guidance for determining whether the analysis has been passed or failed is unclear. Failing the analysis (i.e., the instrument is not a derivative in its entirety) results in splitting the derivative into an at-market derivative with a zero fair value and a loan instrument for the amount of the liability. Passing the analysis will result in continuing to treat the derivative as a derivative instrument with a non-zero fair value. Given the frequency of occurrence and ambiguity of the applicability of the current guidance, we believe the FASB should revisit determining what circumstances require a reassessment of a derivative and the nature of how the analysis described above should be performed. In addition, we believe that IFRS 9 Implementation guidance B.4 addresses this situation more clearly than Topic 815. Modifying Topic 815 to coincide with the IFRS guidance would be a positive step that could remove another GAAP-IFRS difference from practice.

Projects Related to Hedge Accounting Currently on the FASB’s Agenda

Codification Improvements—Hedge Accounting

The objective of this project is to make certain Codification improvements raised by stakeholders on the amendments in Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

With respect to this project, we believe it is critically important to end users to finish addressing Issues 1 and 2 as we believe they have the potential to significantly impact their hedging and risk management activities.

We believe that “Issue 1: Change in Hedged Risk in a Cash Flow Hedge” described in the FASB’s Proposed ASU “Derivatives and Hedging (Topic 815): Codification Improvements to Hedge Accounting” (the Proposed ASU), should be completed and may need to be a separate project rather than a Codification Improvement. The change in hedged risk guidance issued in ASU 2017-12 in paragraph 815-30-35-37A has proven incredibly challenging, if not impossible, to apply in practice to common financial and non-financial hedging situations. Many entities have the option to choose between different tenors of LIBOR currently and may desire shifting their borrowings from one tenor to another under different market conditions. Further, entities may have exposure and the ability to choose between different indexes (or tenors of the same index) as we emerge from reference rate reform (e.g. BSBY, Ameribor, overnight SOFR, and term-SOFR). Entities also regularly encounter situations where they may need/desire to hedge multiple commodity exposures with a single index hedging instrument. It is currently unclear in practice in which situations it is acceptable to apply the change in hedged risk guidance.

A related aspect to changing the hedged risk in a cash flow hedge is that the hedged forecasted transactions need to share the same risk exposure at the inception of the hedging relationship. It is unclear in the guidance and different interpretations exist for what "share the same risk" means for cash flow hedges and whether it is permissible for some or all of the forecasted cash flows to come from multiple indexes in highly correlated/highly effective hedging relationships.

We believe entities will continue to desire to change the risk being hedged and look to multiple exposure indexes as the source of hedged forecasted transactions in both financial and nonfinancial cash flow hedging relationships and we support completion of this project, including separating it from the Codification Improvement project, if necessary.

Regarding "Issue 2: Contractually Specified Components in Cash Flow Hedges of Nonfinancial Forecasted Transactions" in the Proposed ASU, there were several proposed changes we believe would be beneficial to hedgers of nonfinancial risk, which we summarize below and believe are important to finalize:

- For hedging of nonfinancial forecasted transactions and the evidence of a contractually specified component, the exposure draft outlined that the Board's intention was to emphasize the explicit reference to the contractually specified component and not the type of contract containing the reference. This emphasis allows end users to rely upon a multitude of audit evidence to support the existence of a contractually specified component in either an existing or not-yet-existing contract, including invoices, purchase orders or communications from suppliers that include pricing calculations.
- The Board decided to include spot transaction receipts as an example of potential documentation that an entity could use to evidence a contractually specified component. This inclusion expands the application of hedge accounting to stakeholders that purchase or sell non-financial assets in the spot market.
- The exposure draft clarifies that an entity would not need to apply the NPNS scope exception to agreements that qualify as hedged transactions, but rather would only require that entities determine that the underlyings in the agreement are clearly and closely related to the asset being purchased or sold. This clarification removes the burden of analyzing contracts for the NPNS scope exception before the application of hedge accounting.
- The Board also decided to clarify that whether the documentation that includes the explicitly referenced contractually specified component is received before or after the transaction occurs, that timing should not be an impediment to designating the variability in a contractually specified component as the hedged risk in a not-yet-existing contract. This would also expand the supporting evidence for a contractually specified component to invoices or other agreements received after a transaction occurs.

Fair Value Hedging—Portfolio Layer Method

The objective of this project is to expand the existing last-of-layer fair value hedging method from a single-layer model to a multiple-layer model and clarify the accounting for and disclosure of basis adjustments.

Our understanding of this project is that the FASB Staff is currently reviewing feedback received through the comment letter process and will discuss feedback with the Board at an upcoming meeting. We are optimistic that modifications can be made to the proposed Portfolio Layer Method guidance to make it more operationally viable for hedgers and financial risk management purposes. Many entities we work with are waiting to apply the new provisions in the guidance and we encourage the Board to finish this project. Please refer to our comment letter submitted June 28, 2021, for additional feedback.

Reference Rate Reform—Fair Value Hedging

The objective of this project is to monitor reference rate reform initiatives around the world to identify areas of GAAP that may need to be amended in response to those initiatives.

Reference rate reform activities continue to evolve as we near the anticipated cessation of USD LIBOR in June 2023. While some work is underway to effectuate transition away from LIBOR, much of the practical work by both practitioners and auditors is yet to be done. It is likely that as practitioners make progress towards changing financial instruments from LIBOR to non-LIBOR indexes there will be issues that emerge that may need prompt attention from the FASB regarding how to interpret the relief provided in Topic 848. Although the relief is temporary, we believe it is critical for the FASB to remain ready to help address issues that may emerge. Further, the FASB has indicated it will address the current sunset date for the expiration of the relief in Topic 848. We believe it is important to address extending the date timely in order to provide practitioners with ample time to apply the relief and plan for transition out of the relief.

Benchmark Interest Rate Research Project

We understand the FASB Staff is conducting research on whether there should be a change to the definition of a benchmark interest rate under Topic 815 and whether the practice of maintaining a specific list of qualifying US benchmark interest rates should be replaced with a broader principle for determining a benchmark interest rate. We would be supportive of a project to replace the current list of benchmark interest rates with a principle if it would expand the risk management capabilities available to hedgers and create alignment with how benchmark rates are determined outside the US under Topic 815. We do not believe there is a need to finish this project if the outcome would be to create a more restrictive list of benchmark interest rates than currently exists or that maintains the current differences in benchmark interest rate determination within and outside the US under Topic 815.

Hedge Accounting—Phase 2

The objective of the research is to consider ways to further align hedge accounting with risk management activities.

We believe the FASB should undertake its Phase 2 hedge accounting project and it should have a targeted focus on certain aspects of hedging that are currently challenging to apply. We do not believe a comprehensive overhaul is necessary or desirable, but there are a number of issues we believe the FASB could address that would make the guidance easier to apply and more in line with financial risk management activities. We list several of these areas below, which we previously provided in a letter dated January 25, 2019 to Jeffrey Gabello, Supervising Project Manager (which we have included as an Appendix):

- Foreign currency related matters including hedging translation risk, intra-entity transactions, foreign bond issuances, and foreign business combination exposure
- Extending last of layer/portfolio layer methods to fixed rate financial liabilities and reviewing fair value hedging methods in general
- Extending exclusionary treatment to certain basis differences and extending systematic and rational amortization approaches broadly rather than limiting to only certain situations.

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. 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.

Appendix

Jeff Gabello
Supervising Project Manager
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856

January 25, 2019

Suggestions for Agenda Items for FASB's Hedging 2.0 Project

Dear Mr. Gabello:
Thank you for the invitation to suggest topics for a Hedging 2.0 project. We have organized our thoughts into two broad categories:

- High Priority – These items often cause companies to not hedge a material risk because the financial reporting is unacceptable, or to execute the hedge and use non-GAAP measures.
- Low Priority – These items have caused an inordinate amount of confusion and are inconsistently applied in practice. The effort required to comply with these items seems to far outweigh the benefit to users of the financial statements.

We have also ordered these within these categories by expected impact.
We would be happy to discuss any of these items with you at your convenience.

Dan Gentzel and Rob Anderson

High Priority

1. Cash flow hedge of translation risk
   - **Problem**: Forecasted revenues and expenses at foreign denominated subsidiaries drive significant changes in profitability for international companies. Financial statements are full of explanations regarding the impacts of foreign currency. The consolidated entity is exposed to the foreign currency fluctuations when compared to forecasted exchange rates. Because the underlying transactions are in the functional currency of the subsidiary, they do not qualify for Cash Flow Hedge accounting. This is a function only of the functional currency concept and the view of consolidated financial statements as simply a roll up of subsidiaries. The owners of the consolidated company are impacted by these foreign denominated transactions in the same way as they are impacted by foreign denominated transactions in a USD subsidiary.
   - **Proposed solution**: Allow Cash Flow Hedge accounting of translation risk. This can be accomplished by removing the requirement that the entity that holds the derivative must have the foreign currency exposure or by providing an exception for hedge accounting at a consolidated level for these transactions.

2. Exclude CME Basis from hedging relationships
   - **Problem**: There are two primary clearinghouses for interest rates derivatives, LCH and CME. These clearinghouses have different cost structures and, thus, different client bases. Derivatives that clear on CME trade at a positive basis in relation to those that clear on LCH. This CME Basis is not reflected in discount curves used to value hedged items. Changes in CME basis are, therefore, recognized as ineffectiveness in Fair Value Hedging relationships. This ineffectiveness is not reflective of the underlying economics of the relationship and is confusing to readers of financial statements.
   - **Proposed solution**: Add CME Basis to the list of items that can be excluded from hedge effectiveness assessments. Permit recognition of excluded CME Basis on a systematic and rational basis over life of hedging relationship or permit to be marked to market through earnings in accordance with an accounting policy election.

3. Last of layer approach for liabilities
   - **Problem**: Last of layer is unnecessarily restricted to assets. Portfolio hedging activities, such as those allowed under last of layer, occur on both sides of the balance sheet.
   - **Proposed solution**: Extend the ability to apply last of layer hedging to callable/prepayable fixed rate liabilities.

4. Exclude Credit Valuation Adjustment (CVA) from hedging relationships
   - **Problem**: CVA is a valuation only item that is not reflected in the cash flows of an instrument. In Fair Value Hedging relationships, the entity will experience volatility over the life of the instrument that nets to zero. P&L volatility due to changes in CVA is not meaningful information to readers of the financial statements when the hedge is designated in a Fair Value Hedging relationship.
   - **Proposed solution**: Add ASC 820 credit valuation adjustment to the list of items that can be excluded from hedge effectiveness assessments. Permit recognition of excluded CVA on a systematic and rational basis over life of hedging relationship or permit to be marked to market through earnings in accordance with an accounting policy election.

5. Cash Flow Hedges - FX Risk - Forecasted Intra-Entity transactions
    - **Problem**: There is disparity in practice when designating intercompany transactions. Some practitioners believe that intercompany debt principal and coupons are eligible hedged transactions while others believe only intercompany debt principal is eligible. The lack of clear guidance leads to this disparity.
    - **Proposed solution**: Provide further clarity that intra-entity interest payments are an eligible hedged item for a cash flow hedge of FX risk in accordance with ASC 815-20-25-38(d).

6. Fair Value Hedges – Shortcut method for forward starting interest rate swaps
    - **Problem**: When using a series of swaps (both spot starting and forward starting) to hedge two separate partial terms of the same hedged item, a spot starting swap could qualify for the shortcut method but a forward starting swap will not.
    - **Proposed solution**: Allow the shortcut method for forward starting relationships where the hedged item is currently outstanding or there is a recognized firm commitment.

7. Cash flow hedge of interest rate risk in an equity method investment
    - **Problem**: Joint ventures often result in an equity method investment. The venture partners in these relationships often have different appetites for interest rate risk and hedging. Venture level hedging is often only possible when all venture partners agree to hedge. If venture level hedging is not available, an entity that has a lower tolerance for interest rate risk is only able to hedge at the consolidated level and does not have an exposure, separate from the equity method investment, that could be designated. If the company decides to hedge, it must mark the derivative to market through earnings and explain the movements or leave the exposure unhedged. The basis for conclusions to FAS 133 stated that the reclassification of hedge gains/losses to earnings is the reason for the restriction.
    - **Proposed solution**: Allow cash flow hedge accounting of interest rate risk in equity method investments as long as the underlying entity has otherwise qualifying interest rate risk. Allow the reclassification of gains/losses to Income from Equity Method Investment at the same time as the underlying interest rate risk impacts earnings at the investee.

8. Allow inflation as an eligible risk similar to a benchmark interest rate
    - **Problem**: Insurance entities and other holders of long term, fixed-rate contracts are exposed to inflation risk. Inflation is not currently an eligible risk to designate even though it is comparable to interest rate risk in a fixed-rate debt agreement. Inflation risk that is contractually specified is an eligible hedged risk.
    - **Proposed solution**: Allow inflation to be designated on fixed-rate instruments and floating-rate instruments that are not indexed to inflation.

9. Foreign denominated business combination
    - **Problem**: 815-20-25-15(g) disallows business combinations as hedged forecasted transactions. Foreign-denominated business combinations often represent an individually material exposure to the entity. The lack of cash flow hedge accounting for these transactions sometimes causes entities to not hedge this material exposure.
    - **Proposed solution**: Permit foreign currency risk associated with a business combination to be designated as the hedged risk in a foreign currency cash flow hedging relationship. The forecasted transaction could be a specific quantity of foreign currency associated with the purchase price, rather than all changes in the purchase price which may be driven by stock price, volume purchased and other factors. Hedge gains/losses could be recognized in the purchase price of the business and included in the purchase price allocation.

10. FX hedge of the proceeds of a foreign denominated bond issuance
    - Problem: When a company expects to issue a foreign denominated bond, it is exposed to the change in functional currency cash flows related to changes in the exchange rate. Practitioners have taken the view that, while the bond will impact earnings, the proceeds from the bond do not directly impact earnings. However, there are two potential earnings impacts from the bond: (1) when the bond is issued at a premium or discount, the premium/discount is recognized in earnings as an effective yield adjustment and (2) the forecasted interest cost associated with the bond, in functional currency, and forecasted remeasurement of principal also impact future earnings. Because the proceeds do not directly impact earnings (though the resulting principal and interest do) practitioners have disallowed this strategy.
    - **Proposed solution**: Explicitly allow hedges of the proceeds from a forecasted purchase/sale/issuance of a financial instrument to be designated in a cash flow hedging relationship.

11. Cash flow hedge accounting for foreign currency denominated intercompany dividends and comparable cash exposures
    - **Problem**: Foreign currency denominated intercompany dividends present a meaningful economic exposure to many entities but don't qualify for cash flow hedge accounting as the dividends do not impact consolidated earnings. Other foreign currency denominated intercompany transactions are eligible (royalties, etc.) when the transaction itself does not impact earnings.
    - **Proposed solution**: Allow cash flow hedge accounting for foreign denominated intercompany dividends and comparable cash exposures. Reclassification of derivative gains/losses from OCI can occur when the source of the intercompany cash flow impacts earnings (e.g., the sale of the subsidiary).

12. Hedge a partial term of proceeds from a forecasted issuance of debt/hedge a series of interest coupons from the issuance.
    - **Problem**: If the company executes a 10-year swap hedging a future debt issuance that may actually be 7, 10, or 15-year instruments there are different hypothetical derivatives to describe these facts, even though the exposure itself has not changed. In the 7-year scenario, the hedged item is the 7-year instrument plus a refinancing or additional issuance to top up to 10 years. In the 15-year scenario, the issuance is a 15-year instrument, but valued only for changes in the 10-year swap rate. This creates very complicated effectiveness assessments. There is a meaningful distinction between the pattern of OCI release depending on whether the hedged transaction is the interest payments on the forecasted issuance or the proceeds from the issuance.
        i. Interest payments on forecasted issuance: the hedged transactions are a certain number of cash flows and the amount frozen in OCI is amortized over the period of time that those cash flows impact earnings. If the company executes a 10-year swap but ultimately issues a 7-year debt instrument and anticipates having 3 more years of interest payments, then the frozen OCI balance is amortized over 10 years.
        ii. Proceeds from issuance: the hedged transaction is the proceeds from issuance, and if an issuance of a shorter or longer tenor passes the effectiveness assessment, then the frozen OCI balance will be recognized over the life of that instrument. If the entity issues a 7-year debt instrument the entire frozen OCI amount is amortized over 7 years, even if the entity expects to issue 3 more years of debt. If the entity issues a 30-year debt instrument, then the frozen OCI amount is amortized over 30 years, even though the swap was only intended to provide protection over ten years of cash flows.
    - **Proposed solution**: Allow a partial term hedge of the forecasted issuance/proceeds which will allow the frozen OCI balance to be amortized over the number of cash flows hedged.

Low Priority

1. Rework the disclosure of the amounts expected to be reclassified to earnings within one year
    - **Problem**: The amount expected to be reclassified from OCI to earnings during the next twelve months is not a helpful disclosure in its current form. The number is an estimate determined as of a point in time (balance sheet date) and becomes a stale and irrelevant number soon after it is determined. This disclosure is meaningful only when there are amounts frozen in OCI that are being reclassified on a systematic basis. The disclosure is complex to prepare and likely does not provide information that matches forecasts.
    - **Proposed solution**: A more useful disclosure would be to require companies to provide a range within which amounts in OCI are expected to be reclassified into earnings in the following twelve months. Companies could be required to provide estimates that reflect realistic changes in the underlyings of the derivatives comprising the amounts recorded in OCI at the balance sheet date. While this approach clearly requires more work to prepare, many companies likely prepare this or similar information for forecasting purposes or for market risk disclosure information in their SEC filings. We would suggest removing the disclosure altogether if a more useful number is not required to be disclosed than the current number.

2. Revisit DIG G23 forward point allocation method (815-20-55-143 through 55-152) and include examples that are easier to apply
    - **Problem**: The text of DIG G23 does not match the detailed math shown in the example. Only when recalculating the example is it clear that the method of allocation considers discounted spot rates on the cash flows. This allocation method is inconsistent with how financial instruments are accounted for on the balance sheet (remeasured for changes in undiscounted spot rates) and leads to inconsistent application in practice.
    - **Proposed solution**: Align the text and example, preferably by aligning the allocation with the accounting for financial instruments.