

September 21, 2007

Mr. Russell G. Golden
Director of Technical Application & Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 25

Re: File Reference: Proposed Issue E23

Dear Mr. Golden:

Chatham Financial (“Chatham”) is pleased to comment on the Financial Accounting Standards Board’s (the “FASB”) proposed Statement 133 Implementation Issue No. E23, “Hedging—General: Issues Involving the Application of the *Shortcut Method* under Paragraph 68” (“Proposed Issue E23”). Chatham serves as a hedging advisor to over 500 companies in many different industries. Approximately 250 of our clients apply Statement 133 and will be subject to the provisions of the new implementation issue. Chatham assists companies with the implementation of Statement 133 on a daily basis for thousands of derivative transactions, including providing assistance with hedge designation memos, effectiveness testing, derivative valuations, journal entries, and footnote disclosures. Given our role, we believe that we are well-positioned to understand the impact and ramifications of the proposed guidance on a broad spectrum of derivative end users.

General Comments

We are supportive of the FASB’s efforts to clarify issues that have caused implementation difficulties in the application of the shortcut method described in paragraph 68 of Statement 133.

We generally concur with the “Alternative Views” expressed by the three Board members who dissented to the issuance of this implementation issue. We strongly oppose the conclusions reached on late hedging (which we address in detail below); however, we do support most of the conclusions reached in Proposed Issue E23, particularly with respect to the clarifications to the introductory paragraph, that is, permitting a hedging relationship to qualify for shortcut treatment when the relationship is designated on the trade date of both the swap and the hedged item, even though the hedged item is not recognized for accounting purposes until the transaction settles (provided that settlement occurs within

established marketplace conventions). With respect to that issue in particular, we applaud the Board for reaching a conclusion that appropriately aligns the accounting treatment with the underlying economics of the transaction.

We also agree with the Board's conclusions regarding:

- Paragraph 68(a) and its application to principal pay-downs prior to maturity;
- Paragraph 68(b) and its application in the marketplace under Statement 157;
- Permitting application of the shortcut method when the coupon rate of the hedged item is rounded in accordance with normal market conventions; and
- Prohibiting shortcut treatment for hedges of zero-coupon financial instruments.

We had hoped that the Board would eliminate (preferably) or more fully clarify paragraph 68(e), which we believe will continue to cause difficulties in practice. Essentially, **paragraph 68(e) amounts to a very vague principle embedded in a strictly interpreted rule.** We question whether there is any consistent understanding of the word "typical" and are concerned that the ambiguity will expose preparers to ongoing interpretation (and re-interpretation) risk by auditors and regulators. At a minimum, we would recommend that the Board insert the word "critical" before each reference to "terms" in paragraph 68(e), so that "critical terms" are emphasized and an insignificant and/or immaterial provision in a hedged item is not used as the basis for precluding shortcut treatment in practice.

In addition, the paragraph 68(e) requirement that the terms "not invalidate the assumption of no ineffectiveness" is likewise very confusing, since all fair value hedging relationships in practice inherently have some ineffectiveness. We believe that the Board made three direct exceptions to that requirement, even though paragraph 68(e) does not mention any of them. However, they are provided for elsewhere in the guidance. More specifically, we would note that (1) paragraph 68(h) allows for repricing frequencies on the swap's floating leg of "three to six months or less" even though not invalidating the assumption of no ineffectiveness would require that the swap's floating leg reset *continuously* to par (which is never observed in the marketplace), (2) paragraph 70 allows for non-comparable credit risk related to the parties to a swap (paragraph 70 indicates that "comparable creditworthiness is not considered a necessary condition to assume no ineffectiveness"), and (3) as noted in our discussion below, the guidance also implicitly and explicitly indicates in various paragraphs that late hedges do not violate the assumption of no ineffectiveness.

Late Hedging – Review of Current Guidance

Most significantly, we do not agree with the issuance of Proposed Issue E23 due to the Board’s conclusion regarding late hedging. We firmly believe that late hedges have always qualified for shortcut treatment and that such treatment is clearly permitted by Statement 133, as indicated by the following:

- The absence of any discussion of the hedged item being required to have a fair value equal to its par value in paragraph 68;
- The absence of any discussion of the hedged item being required to have a fair value equal to its par value anywhere in the hundreds of pages of authoritative guidance on Statement 133;
- Paragraph 114, which specifically refers to the need to consider amortization of any purchase premium or discount—*indicating that the fair value of the hedged item does NOT equal par*—when applying the steps in the shortcut method;
- Paragraph 115, which **explicitly and unequivocally** states that the trade date and borrowing date of the interest rate swap and fixed-rate debt “need not match for the assumption of no ineffectiveness to be appropriate. (Refer to paragraphs 68 and 69.)” We believe that the guidance is absolutely clear on that point, and that this provision in paragraph 115 was included specifically to permit shortcut treatment for situations in which a swap was entered into subsequent to the origination/borrowing date of an existing financial instrument [now referred to as “late hedging”]); and
- Statement 133 Implementation Issues E10, E15, and J9.

Given the references noted above, we were perplexed by the use of Statement 133 Implementation Issue No. E15 (“Issue E15”) as support in Proposed Issue E23 for prohibiting late hedging; in our view, Issue E15 is yet another clear indication that the current authoritative guidance expressly permits late hedging. Issue E15 appropriately notes that the swap fair value would be unlikely to equal zero at the date of a business combination (making continuation of shortcut very unlikely), but Issue E15 is silent as to the hedged item needing a fair value equal to par. We strongly believe that if the latter were actually a requirement, there would have been at least a single reference to it somewhere in the vast authoritative guidance, and Issue E15 would have been an obvious and important place to mention it.

Given the substantial evidence in the existing guidance that late hedges qualify for shortcut treatment, we were surprised that late hedging is even being addressed in this shortcut clarification project. We are not aware of any diversity in practice regarding its application, and we question any need to “fix” or “clarify” something that is working well in practice and that is widely accepted and understood.

Late Hedging – Support for Continued Application Under the Shortcut Method

Regardless of one’s interpretation of the existing guidance, we certainly respect the Board’s right and responsibility to set current financial standards and to change prior standards when they believe it will improve financial reporting. However, we strongly believe that the original Board decision was correct and that late hedges should be afforded shortcut treatment under Statement 133.

Setting all else aside, the shortcut method results in a faithful representation of an entity’s risk management objective and strategy to simply “swap the coupon” of a fixed-rate instrument to floating. Based on our experience with thousands of swap transactions, we believe that the financial statement results produced under the shortcut method represent an accurate reflection of the underlying substance of such transactions. Accordingly, there is no need to overcomplicate the accounting for late hedges. Shortcut accounting treatment remains true to the cash flows and floating-rate yield achieved by “late hedge” transactions, and we do not believe that the shortcut results are misleading to users or investors (and we would note that the same cannot necessarily be said for many long-haul methodologies).

As noted above, paragraph 68 permits an assumption of no ineffectiveness.....even though some ineffectiveness always exists in fair value hedging relationships (for example, due to the non-comparable creditworthiness of the parties to the swap and a non-continuous reset frequency on the swap’s floating leg). As further noted above, we believe that a third, permitted source of ineffectiveness under the shortcut method is due to late hedging, and that such ineffectiveness should not be a concern to current Board members because the income statement results provided by the shortcut method are representationally faithful to the underlying substance of the transactions.

The discussion and computations below illustrate the viewpoint articulated by the three Board members in the Alternative Views section that “changes in the fair value of a debt instrument prior to the hedge transaction do not distort the effectiveness of the hedging relationship going forward, provided that the terms of the swap match the remaining terms of the debt. In that case, it is still reasonable to assume that changes in the fair value of the swap will be highly effective in offsetting subsequent changes in the fair value of the debt attributable solely to subsequent changes in the benchmark interest rate.”

To illustrate this point, we have included the results of a “late” hedging relationship—from execution to maturity—during the five year period from January 1, 2001 to December 31, 2005 (using actual interest rate curves). This time period is particularly illustrative because there were both significant decreases and significant increases in rates, and we believe it is reflective of reasonably possible interest rate environments going forward.

The hedging relationship in the example below is a fair value hedge of existing, fixed-rate debt. The hedging relationship is assumed to be established/documentated when the swap is executed, one year after the issuance of the debt (a “late hedge” situation). The measurement of ineffectiveness is based on the methodology illustrated in paragraph 120C, which excludes the effect of the passage of time and is one methodology illustrated by Statement 133 to determine changes in fair value attributable solely to changes in the benchmark interest rate. In addition, *to isolate the effect of late hedging on the hedging relationship*, we have assumed that the company is able to borrow at LIBOR flat (no spread to LIBOR), that comparable creditworthiness exists between the parties to the swap, and that the floating leg of the swap resets precisely to par at each measurement date. The following table lists the terms of the debt and swap used in the example.

Term	Debt	Swap
Trade Date	1/1/2001	1/1/2002
Maturity Date	12/31/2005	12/31/2005
Coupon / Receive Fixed Rate	5.924%	4.741%
Principal / Notional	\$100,000,000	\$100,000,000
Term	5 Years	4 Years
Floating Leg Index	N/A	3-month LIBOR
Spread on Floating Leg	N/A	0 basis points
Day Count Convention	30/360	Receive 30/360 / Pay Act/360
Payment & Business Day Convention	Modified Following	Modified Following

The table below illustrates the results of our calculations and fully supports the viewpoint expressed by the Board members in the Alternative Views. The information includes the changes in fair value of the swap and the hedged fixed-rate debt attributable solely to changes in the benchmark interest rate (LIBOR), the dollar amount of ineffectiveness, and the ineffectiveness percentage (comparing the dollar amount of ineffectiveness to the change in the swap’s fair value).

Date	Changes in Fair Value		Ineffectiveness	
	Swap (B/S)	Fixed-Rate Debt (B/S)	Ineffectiveness (Dollar Amount)	Ineffectiveness (Percent of Swap Change in Value)
1/1/01	-	-	-	-
3/31/02	(164,476)	158,148	6,328	-3.8%
6/30/02	3,896,029	(3,984,751)	88,722	2.3%
9/30/02	4,902,537	(4,989,416)	86,879	1.8%
12/31/02	955,695	(975,769)	20,074	2.1%
3/31/03	917,996	(933,238)	15,242	1.7%
6/30/03	1,326,425	(1,342,026)	15,601	1.2%
9/30/03	(211,130)	211,757	(627)	0.3%
12/31/03	(275,578)	277,997	(2,419)	0.9%
3/31/04	990,802	(999,784)	8,982	0.9%
6/30/04	(1,429,047)	1,442,364	(13,317)	0.9%
9/30/04	562,394	(566,923)	4,529	0.8%
12/31/04	(337,484)	339,752	(2,268)	0.7%
3/31/05	(266,491)	267,706	(1,215)	0.5%
6/30/05	58,305	(58,547)	242	0.4%
9/30/05	(63,434)	63,619	(185)	0.3%
12/31/05	-	-	-	-
	10,862,543	(11,089,111)	226,568	2.1%

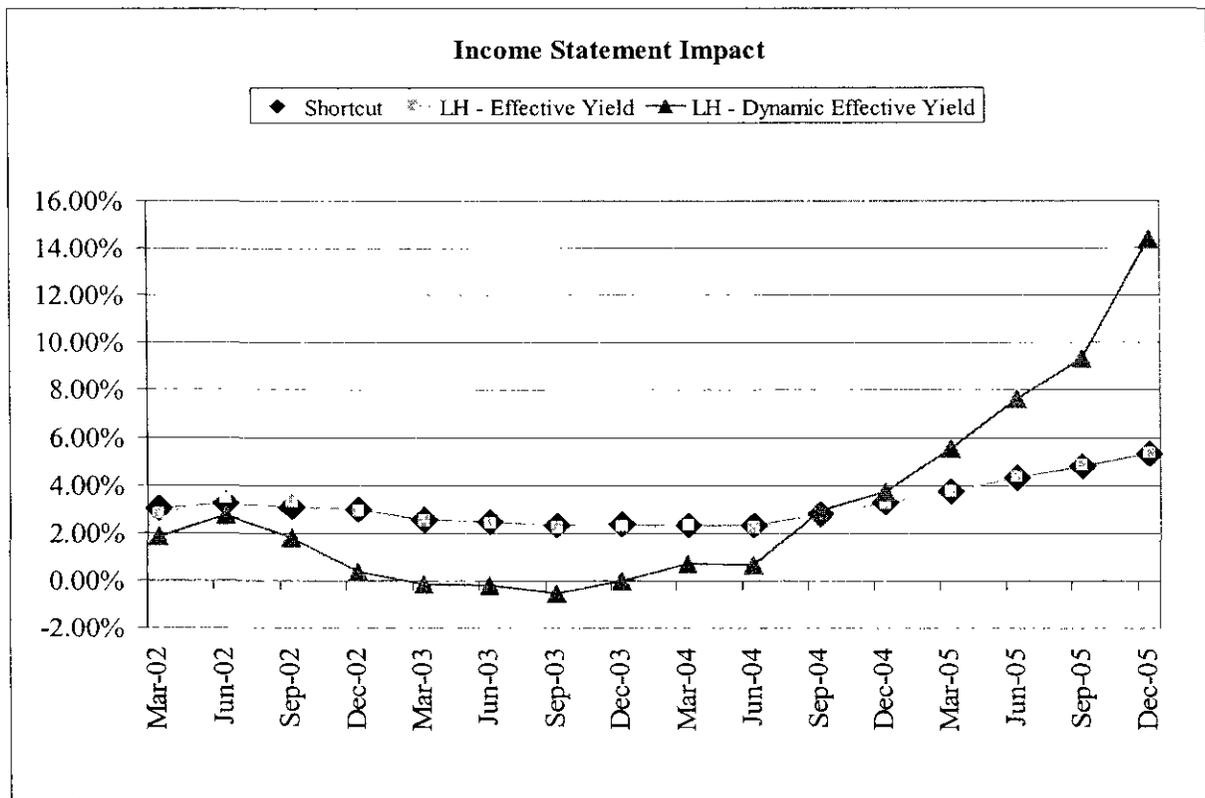
As the table illustrates, and as suggested in the Alternative Views, changes in the fair value of the swap are highly effective in offsetting subsequent changes in the fair value of the debt attributable solely to subsequent changes in the benchmark interest rate, even though the swap was executed one year after the hedged debt was issued. The amounts of ineffectiveness calculated above are not significant to the overall hedging relationship—they average only about 2% of the change in the fair value of the swap.

What about Amortization of the Pre-Hedge Gain or Loss?

The Alternative Views continues: “Other accounting standards would govern the recognition in earnings of any premium or discount on the hedged item prior to the inception of the hedge. That element does not represent ineffectiveness in the current hedging transaction.” We also agree with that statement and believe that the diversity in practice and complications caused by various amortization methodologies represent another benefit of the shortcut method. In short, since the hedged item’s fair value is different than its par value at the inception of the hedging relationship, the hedged item will “pull to par” over time (as time passes) regardless of movements in interest rates. We

do not believe that this represents ineffectiveness in the current hedging relationship (since the prehedge gain or loss occurred before the hedging relationship was established), but the income statement results of various methodologies to deal with that initial difference between fair value and par value of the hedged item can vary greatly. One significant advantage of the shortcut method is that it implicitly “amortizes” that difference via the swap accruals over the life of the hedging relationship naturally and automatically....and in a manner that reflects the underlying economic substance.

Unfortunately, under certain of the various measurement and amortization methodologies prescribed by some in practice, similar results cannot be replicated under long-haul (and the income statement results can be very misleading). As an example, note the income statement results in the following graph of shortcut and the income statement results of long-haul using two different amortization methodologies: effective yield (amortizing the difference between fair value and par value as of the inception of the hedging relationship on an effective yield basis over the life of the hedged item) and dynamic effective yield (reperforming a new effective yield calculation every period based on the cumulative adjustment to the hedged item’s carrying amount).



The line with diamonds represents the amount recognized in the income statement for the example hedging relationship when shortcut is applied. The line with squares represents the amount recognized in the income statement when long-haul is applied (using a “clean-to-clean” approach, as illustrated in the examples to Statement 138) and simple effective yield amortization. The line with triangles represents the same long-haul measurement approach as the line with squares, except that dynamic effective yield amortization is used. As illustrated in the example, certain methodologies like simple effective yield (but also others like “swap method amortization” and “time decay”) are reflective of the cash flows and underlying substance of the transactions, and the income statement results approximate the “implicit amortization” of the shortcut method. However, other methodologies, like dynamic effective yield—which some believe is required/prescribed by Statement 133—produce nonsensical results. Note that dynamic effective yield produces results that are artificially low in initial periods (actually resulting in negative interest expense in certain periods that would be reflected in the financial statements)...and artificially high in the later periods (over 14% in the final period!) as the amortization is forced to “catch-up” to adjust the hedged item back to par. Fortunately, the shortcut method is immune from those types of ridiculous income statement results that we believe are extremely misleading to users of the financial statements.

Finally, it is important to note that we have isolated the impact due to late hedging under various amortization methodologies in the graph above to illustrate the effect of those particular methods. In practice, however, a long-haul approach would also need to incorporate the other sources of ineffectiveness expressly permitted by the FASB under the shortcut method, perhaps most significantly the credit spread inherent in the hedged item. We would note that incorporating those elements under long-haul frequently adds significant volatility to the income statement results, despite the fact that the company perfectly accomplished its risk management objective and precisely hedged the risk it was economically intending to hedge.

Effective Date and Transition

If the Board determines that late hedging should be permitted under the shortcut method going forward, then we believe the effective date and transition provisions provided in Proposed Issue E23 are fair and reasonable. However, as currently drafted (with a prohibition against late hedges qualifying for shortcut), the effective date and transition provisions are unfair and inadequate. Given the complexities involved in transitioning existing shortcut hedges to a long-haul approach, a much longer implementation period than a few weeks will be required. Companies cannot be expected to simply “flip the switch” and move to long-haul hedge accounting. They will need a reasonable time period to develop systems, resources, documentation, and internal controls necessary to comply with the significantly more complicated long-haul requirements.

As an alternative to a delayed effective date, we would propose that that Board also consider grandfathering existing positions (if late hedging is ultimately prohibited under the shortcut method). Given the widespread consensus that late hedges currently qualify for shortcut treatment, grandfathering would seem to represent a more equitable and balanced approach to transition. In particular, it would resolve any issues associated with existing hedges that some companies inevitably will feel compelled to terminate (even though such hedges are needed for risk management purposes) due to the additional cost, complexity, and administrative burden imposed by long-haul hedge accounting.

Conclusion

We are supportive of most of the Board's clarifications to the shortcut method, but strongly oppose its conclusion to prohibit late hedges from qualifying for shortcut treatment. We believe that a prohibition against late hedging would affect numerous current and future transactions (for example, shortcut would not be available for almost any purchased asset or investment, and companies would be unable to qualify for shortcut hedges of debt or other liabilities at any point after original issuance). Such a significant change to current practice is simply not justified in the circumstances, as it does not represent an *improvement in financial reporting*. *Shortcut treatment for late hedges is a faithful representation of a company's risk management objective and strategy of "swapping the coupon" of a fixed-rate instrument to floating, and we believe that shortcut remains true to the underlying economics and substance of those transactions (which is not always true in practice with various long-haul approaches).* Accordingly, we strongly recommend that the Board continue to permit late hedging under the shortcut method.

We thank the Board for its consideration of our recommendations 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) 731-0235 or at cmaxwell@chathamfinancial.com.

Sincerely,

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