

March 2, 2007

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



LETTER OF COMMENT NO. 39

Re: File Reference No. 1510-100, Proposed Statement of Financial Accounting Standards, *Disclosures about Derivative Instruments and Hedging Activities*

Dear Mr. Smith:

Chatham Financial (“Chatham”) is pleased to comment on the Financial Accounting Standards Board’s (the “FASB”) proposed Statement of Financial Accounting Standards, *Disclosures about Derivative Instruments and Hedging Activities* (the “Exposure Draft”). 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 standard. 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 many different users of derivatives.

General Comments

Objective

We are supportive of the FASB’s efforts to improve disclosures related to derivatives and hedging activities. We believe the current disclosure requirements can be improved to increase transparency and to help users better understand the effects that derivatives have on an entity’s overall financial position, results of operations, and cash flows.

In our opinion, the Exposure Draft generally takes a step towards improved transparency, although we believe certain modifications are needed to meet the stated objectives, given that some of the proposed requirements add unnecessary complexity and/or may even impair the usefulness of the information to financial statement users, particularly when

the information presented is misleading in nature. We are also concerned that the incremental costs of providing certain disclosures outweigh the perceived benefits.

Review of Existing Disclosure Requirements

We believe this project provides a good opportunity to review the usefulness of certain disclosures currently required by Statement 133. We are hopeful that in the course of this project the FASB will not only add to or enhance the existing disclosures, but also candidly assess which currently required disclosures should be deleted because they fail to meet the cost/benefit requirements.

For example, we specifically recommend that the FASB reconsider and remove the current disclosure requirement in paragraph 45(b)(2) related to “the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months.” We doubt that either users or preparers find that information to be useful. The reclassification for active hedges is based on the forward curve at the end of the period, which changes the moment the value is calculated. Such estimations do not provide any meaningful information and could mislead users into believing that a reliable estimate exists for determining how the derivative will affect income over the next 12 months. In essence, that disclosure (1) represents only a “guesstimate” that is inevitably incorrect, (2) is not readily available because it is not used in an entity’s day-to-day accounting, (3) is time consuming to calculate, and (4) fails to acknowledge or recognize the offsetting impact from the hedged transactions, which we believe makes the disclosure particularly misleading because it represents only a partial view of the hedging relationship. Accordingly, we recommend that this disclosure be reconsidered as part of the FASB’s ongoing deliberations.

Scope

We believe that the scope of the Exposure Draft is appropriate if the FASB’s objective in issuing the proposed guidance is enhanced transparency related to:

- How and why an entity uses derivative instruments;
- How derivative instruments and related hedged items are accounted for under Statement 133; and,
- How derivative instruments affect an entity’s financial position, results of operations, and cash flows.

Based on our review of the Exposure Draft, particularly the Basis for Conclusions, we believe some ambiguity exists as to the FASB’s objective relative to increased transparency regarding how entities manage their overall risk. We do not believe that the scope of the Exposure Draft is sufficiently comprehensive to include overall risk management information. If the FASB’s intent is to provide more comprehensive

disclosures regarding an entity's overall risk management process, we strongly agree with the alternative described in paragraph B8 for the reasons sighted therein. Many hedging strategies do not involve derivatives in qualifying hedging relationships, or they utilize other financial instruments to hedge an entity's financial risks. While the Board reasoned that a more encompassing project would not address the users' immediate needs in a timely enough manner, the proposed guidance could impair the ability of users to understand an entity's overall risk management strategy, as it would provide an incomplete picture of that strategy.

Specific Concerns

We have some concerns relative to the proposed guidance, particularly relating to the disclosure frequency, effective date, and contingent features. Our comments relative to disclosure frequency are addressed in the following paragraph. Our comments related to the effective date and contingent features are incorporated into our responses to the specific issues posed in the Exposure Draft in the pages that follow. The specific comments below also provide support for the general comments above and outline alternatives for the FASB's consideration.

Disclosure Frequency

One of our primary concerns relates to the disclosure frequency. Regulators are allowing for less and less time to prepare the financial statements (as filing deadlines are compressed and accelerated), while the number of complex accounting standards is increasing and the volume of required disclosures is expanding. The combination seems overly burdensome for many preparers.

Accordingly, for most entities, we believe that the original guidance in paragraph 45 to provide derivative disclosures "for every reporting period for which a complete set of financial statements is presented" is sufficient. Therefore, we would recommend that interim disclosures not be required, except when (1) derivatives are considered significant to the entity's operations or (2) there is a significant change in the entity's use of derivatives or hedging activities during the quarter. Alternatively, disclosures could be encouraged (but not required) on an interim basis. We believe this one modification to the Exposure Draft would significantly reduce the cost of implementation for most entities, and we urge the FASB to reconsider this requirement.

Comments on Specific Issues Posed by the FASB

Scope

Issue 1:

The Board concluded that prescriptive guidance about how derivative instruments should be presented and classified in the financial statements should be excluded from the project's scope. Including presentation and classification guidance could potentially delay issuing a standard that would significantly improve the transparency about derivative instruments and hedged items. In addition, various presentation and classification issues related to derivatives and hedged items have an impact on the Board's current project on financial statement presentation and also would need to be addressed in the context of that project.

Do you agree with the Board's decision to exclude from the scope of this proposed Statement prescriptive guidance about how derivative instruments should be presented and classified in the financial statements? Why or why not? (See paragraphs B5–B11 for the basis for the Board's conclusions.)

We agree with the Board's conclusion to exclude prescriptive guidance regarding how derivative instruments should be presented and classified in the financial statements from the scope of the proposed Statement. We agree with the conclusion for the same reasons the Board considered in paragraph B10, particularly the comment that "Statement 133 has an underlying elective nature and entities identify and manage risk in different ways." Due to the variety of ways that entities use derivatives to manage various risks, providing prescriptive guidance on financial statement presentation and classification that would appropriately provide for the economics of each of the various uses of derivatives would be difficult to achieve.

Issue 2:

Statement 133 applies to both public and private entities. The requirements in this proposed Statement also would apply to both public and private entities.

Do you agree that this proposed Statement should apply to both public and private entities? Why or why not?

We support the FASB's tentative decision to require both public and private companies to comply with the proposed guidance. The use of derivative instruments to manage financial risks is not dependent on whether an entity is public or private, and private companies are generally exposed to the same risks as public companies. Accordingly, it

is our view that all users would benefit from a better understanding of how an entity manages its risks through the use of derivative instruments.

Costs of Implementing the Proposed Statement's Disclosure Requirements

Issue 3:

This proposed Statement would require an entity to provide information on derivative instruments (including, but not limited to, notional amounts and fair value amounts), hedged items, and related gains and losses, by primary underlying risk, accounting designation, and purpose in the tabular format shown in Appendix A.

Do you foresee any significant operational concerns or constraints in compiling the information in the format required by this proposed Statement? Are there any alternative formats of presentation that would provide the data more concisely? (See paragraphs B18–B20 for the basis for the Board's conclusions.)

We generally support the tabular format suggested in the Exposure Draft to aid in achieving greater transparency in derivative disclosures. However, we are concerned with the level of disaggregation required by paragraph 44C. If the information provided in the tables is too detailed or overly granular, we believe it may impair the transparency of the information rather than improve it. Paragraph 44C could require seven tables (or more) to disclose derivative information for each underlying risk or combination of risks. Additionally, the guidance is unclear as to how an entity would aggregate different currency and commodity hedges into the tabular format (for example, should separate tables be included for different currencies, particularly when the USD is not one of the currency pairs? Is it workable to combine all types of commodity hedges in one table?).

Much of the detailed information required in the tabular disclosures is not currently tracked separately (for example, income statement impact of positions no longer open at period end) and would, therefore, require a substantial amount of work to disaggregate. *We believe many entities will face operational challenges in providing the level of detail required.* In addition, the table also lists derivative notional and fair value amounts separately by asset and by liability position, including the corresponding impacts on the income statement. Since the same derivative can be an asset in one reporting period and a liability in the next reporting period, linking this information to the income statement will be especially difficult to track and may be quite confusing to the user. Based on the full page needed to explain a small number of derivatives in the Exposure Draft example, it is reasonable to assume that the proposed guidance could expand the overall length of disclosures considerably, even for relatively infrequent derivative users. Accordingly, we recommend that the tabular disclosures be aggregated by primary underlying risks as

defined in Statement 133 and not require separate tables for multiple risks. We especially recommend that the income statement impact (and, for cash flow hedges, the impact on OCI) be provided in aggregate for each line item only (purpose), rather than being shown separately by asset and by liability and by positions no longer open at period end. As mentioned above, such information would be very difficult to track and would likely be confusing.

Issue 4:

This proposed Statement would require disclosure of (a) the existence and nature of contingent features in derivative instruments (for example, payment acceleration clauses), (b) the aggregate fair value amount of derivative instruments that contain those features, and (c) the aggregate fair value amount of assets that would be required to be posted as collateral or transferred in accordance with the provisions associated with the triggering of the contingent features.

Do you foresee any significant operational concerns or constraints in compiling that information for this disclosure? (See paragraphs B39–B42 for the basis for the Board’s conclusions.)

Due to the lack of clarity regarding what constitutes a “contingent feature” within the Exposure Draft, we would not support the currently proposed disclosures related to contingent features. For example, a typical ISDA agreement generally includes many features that could be considered “contingent” under the proposed guidance. For example, these features include, but are not limited to:

- Numerous termination events, ranging from action taken by a taxing authority to events of merger;
- Mutual puts (whether or not these features are considered “contingent” has already generated significant debate among preparers);
- Reference to certain financial measurements or covenants, such as net worth or net asset value requirements;
- Cross default provisions whereby the derivative could be called if the entity failed to perform on any of its other obligations;
- Failure to meet any obligation other than payment on the derivative, such as failure to provide required documents;
- Financial misrepresentation, such as if a party to the derivative was required to restate their financial statements; and

- Force majeure events (for example, in the event of a natural or man-made disaster, labor riot, act of terrorism or other unanticipated event that prevents a party from performing under the derivative, the obligation may be deferred for no more than 8 local business days before the counterparty may terminate the transactions affected by the event).

Although the examples in the Exposure Draft appear to relate primarily to credit events, we are concerned that “contingent features” could be interpreted broadly enough by auditors and regulators to scope in a large number of items, and we’re concerned about the potential for endless “second guessing” unless the FASB clarifies its intent.

Additionally, while many “contingent features” are standard to ISDA agreements, many are negotiated by each party. As currently worded, the proposed guidance implies that almost any term contained in the Credit Support Annex (CSA) of the ISDA agreement may have to be included in the disclosures. This information can be detailed and may differ significantly for each counterparty. Many users of derivatives may have differing terms with each of a dozen or more counterparties that can be based on market value of assets, certain financial ratios, or credit ratings (ratings-based thresholds are common in practice). Compiling this information could lengthen the disclosure significantly and may reveal competitive information that would prove detrimental to the derivative user’s ability to negotiate terms with other counterparties (similar to the issues discussed in paragraph 508 of Statement 133). **The revealing of proprietary and competitive information is a major concern for many of our clients and may be detrimental to their negotiations with new counterparties.**

Finally, many contingent features are not tracked at an entity level and it would be challenging and time consuming to capture and disclose that information.

Therefore, at a minimum, we strongly recommend that the FASB clarify that contingent features as described in the Exposure Draft relate only to those events related to a deterioration in an entity’s creditworthiness (or otherwise explain precisely what is intended). Furthermore, we recommend that the required disclosures be modified to provide more general information as opposed to the granular, specific disclosures illustrated in the example. For example, perhaps the guidance could require disclosure of the aggregate amount of collateral that would be required to be posted if the entity was downgraded one notch and/or below investment grade.

Disclosure of Notional Amounts

Issue 5:

This proposed Statement would require disclosure of notional amounts in tables that also will include fair values of derivative instruments by primary underlying risk, accounting designation, and purpose.

Do you agree that this proposed Statement should require the disclosure of notional amounts? Why or why not? (See paragraphs B21–B25 for the basis for the Board's conclusions.)

In many instances, particularly for entities with less sophisticated hedging strategies, disclosure of the notional amounts will meet the Board's stated objectives and will be useful to users of the financial statements. Many preparers currently disclose information on notional amounts. In addition, disclosing the notional amounts of derivative instruments in the proposed tabular format would not be operationally difficult.

However, we are concerned that in certain circumstances disclosure of notional amounts may be more misleading than informative. For example, many lender required caps, which are very common in the real estate industry, have large notional amounts, high strike rates, and sometimes short terms to maturity. Disclosure of the notional amounts in such situations is probably more misleading than informative. For example, the potential impact of a \$1 billion notional, 8% LIBOR cap that matures in one month is negligible, while the potential impact of a 30-year, \$50 million notional swap could significantly impact an entity. Thus, in many cases, disclosure of the notional amount is not indicative of either the derivative volume or risk exposure that an entity faces.

Additionally, certain hedging strategies utilize a series of sequential forwards rather than a swap. Although the strategies are economically equivalent, disclosing the aggregate notional of the forwards would significantly overstate the impact and would be very misleading without complete disclosure of all the terms of the derivatives used in the hedging strategy. Similarly, disclosing the notional amounts of sequential swaps that "step up" the yield curve over time would likewise be misleading. A \$100 million, 5-year swap is economically equivalent to 5 sequential forward-starting swaps (each with a 1-year tenor), but the notional would show \$500 million for the forward-starting swaps versus only \$100 million for the single swap. In both cases, only \$100 million in debt is being hedged.

Finally, attempting to disclose the notional amounts in the tabular format required could be cumbersome for different types of foreign currencies and for the many different types of commodities.

In general, we believe risk information would be much more effectively communicated via various risk metrics (such as stress testing or VAR) rather than through disclosure of notional amounts, which has significant limitations. Unfortunately, the added complexity would likely be a significant burden for less sophisticated entities. Therefore, perhaps a reasonable compromise would be to provide flexibility to companies in how they provide information on the volume and the magnitude of risks being hedged (in other words, require disclosure of notional amounts or require disclosure of certain risk metrics if an entity believes it provides the user a more complete and accurate picture of its derivative activity). At a minimum, perhaps the guidance should require disclosure of either the derivative notional amounts or the corresponding face/principal amounts of the related hedged items (which would resolve some of the concerns regarding notional amounts that we noted above).

Issue 6:

This proposed Statement would require disclosure of gains and losses on all derivative instruments that existed during the reporting period regardless of whether those derivatives exist at the end of the reporting period. This proposed Statement would not require disclosure of the aggregate notional amounts related to those derivatives that existed during the reporting period but no longer exist at the end of the reporting period.

Do you agree that this proposed Statement should not require the disclosure of the aggregate notional amounts related to derivatives that no longer exist at the end of the reporting period? Why or why not?

We agree that disclosing income statement information on all derivative instruments that existed during the period, including those positions no longer open at period end, is useful and relevant to users of the financial statements. We also agree that disclosure of aggregate notional amounts related to derivatives that no longer exist at period end is irrelevant and should not be required.

As noted above in our response to Issue 3, however, our primary recommendation with respect to this issue is that the income statement impact (and, for cash flow hedges, the impact on OCI) be provided in only aggregate for each line item (purpose), rather than being shown separately by asset and by liability and by positions no longer open at period end.

Disclosure of Gains and Losses on Hedged Items

Issue 7:

This proposed Statement would require disclosure of the gains and losses on hedged items that are in a designated and qualifying hedging relationship under Statement 133. The Board decided that an entity would not be permitted to include information in the tables on “hedged items” that are not in designated and qualifying Statement 133 hedging relationships because “economic hedging” means different things to different people.

Do you agree that information about “hedged items” that are not in designated and qualifying Statement 133 hedging relationships should be excluded from the disclosure tables? Alternatively, should the tables include gains and losses on “hedged items” that are recorded at fair value and are used in hedging relationships not designated and qualifying under Statement 133? Why or why not? Would your answer be affected by the forthcoming FASB Statement on the fair value option for financial assets and financial liabilities, which will provide the option to report certain financial assets and liabilities at fair value? (See paragraphs B33–B35 for the basis for the Board’s conclusions.)

We agree with the Board’s conclusion to limit disclosure of gains and losses on hedged items to only those items in qualifying hedging relationships. Including the gains and losses that are not calculated based on consistently understood and applied principles contained in Statement 133 provides an opportunity for gains and losses of unrelated items be included to give the appearance of effective offset. Without the linkage provided by qualifying Statement 133 hedging relationships, it would be difficult for users to understand what is included in the gains and losses presented.

However, we believe that the current format of disclosing gains and losses on derivatives in non-qualifying hedging relationships is fairly misleading. For example, many financial institutions utilize “back-to-back” hedging strategies in which they offset the exposure of one derivative (perhaps offered to a customer) by entering into a mirror-image derivative with another counterparty, such that the gains and losses precisely offset. Similarly, when a derivative is no longer needed to manage a particular risk, it is often offset by another derivative rather than cash settled. The currently proposed tabular display could mislead users into thinking that an entity is incurring significant gains and losses, when in reality, the gains and losses are largely or even completely offset. Accordingly, we suggest that any information regarding derivatives not in qualifying hedging relationships be shown net instead of gross.

Finally, within the table, we would recommend aggregating information on derivatives not designated in a hedging relationship, rather than artificially segregating those derivatives based on the “reason why the derivative is held.” We believe aggregating that

information would simplify and shorten the tables and would promote consistency.....without any meaningful loss of information, since a description of the purpose of the derivative activity for derivative instruments not designated as hedges is already required under paragraph 44.

Amendments Considered but Not Made

Issue 10:

The Board considered but decided against requiring additional disclosures as described in paragraphs B55–B63. Those disclosures focused on providing information on an entity’s overall risk management profile, methods for assessing hedge effectiveness, and situations in which an entity could have elected the normal purchases and sales exception.

Do you agree with the Board’s decisions not to require disclosures in those areas? Why or why not?

We agree with the Board’s decision not to include these additional disclosures.

Effective Date

Issue 11:

The Board’s goal is to issue a final Statement by June 30, 2007. The proposed effective date would be for fiscal years and interim periods ending after December 15, 2007. At initial adoption, comparative disclosures for earlier periods presented would be encouraged, but not required. Beginning in the year after initial adoption, comparative disclosures for earlier periods presented would be required.

Does the effective date provide sufficient time for implementation? (See paragraphs B50–B53 for the basis for the Board’s conclusions.)

The effective date of the proposed Statement for interim and annual reporting periods ending after December 15, 2007 would be burdensome for many preparers. The proposed effective date requires disclosure of information related to the current year (2007) that is not currently being tracked by many derivative users, and capturing that information will require significant changes to existing systems. Given that the proposed Statement likely will not be finalized until sometime during the second quarter of 2007, preparers will have very little time to implement the changes necessary to capture the required information, and they will have to manually gather all of the data for periods prior to any system changes (the first half of 2007). Additionally, entities are

concurrently working on system changes related to the implementation of Statement 157 and Statement 159. Given these constraints, we would strongly advocate that the FASB make the effective date no earlier than fiscal years ending after December 15, 2008.

We thank the Board for its consideration 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) 731-0005 or at rbergstrom@chathamfinancial.com.

Sincerely,

Ryan Bergstrom
Financial Institutions Group
Chatham Financial Corporation