



The Association of  
Accountants and  
Financial Professionals  
in Business

July 7, 2021

Ms. Hillary H. Solo  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

Re: File Reference No. 2021-002

Dear Ms. Solo:

The Financial Reporting Committee (FRC or Committee) of the Institute of Management Accountants (IMA) is writing to share its views 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* (Proposed Update).

The IMA is a global association representing over 140,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The Committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at [www.imanet.org](http://www.imanet.org) (About IMA, Advocacy, Financial Reporting Committee).

The Committee supports the Board's efforts to improve the current last-of-layer method for fair value hedges. Further, we agree with the Board's objectives to expand the current single-layer model and to provide clarification on both the hedging instruments that are eligible to be used in a single-layer hedge relationship and the accounting for basis adjustments applicable to the portfolio layer method. We agree that entities should be permitted to use multiple-layer hedges for a single closed portfolio of financial assets or beneficial interests supported by a portfolio of financial assets. We applaud the Board's efforts with respect to this Proposed Update and support the majority of its provisions. We have identified several improvements to the Proposed Update that are further discussed below.

### **Scope**

The Committee believes that a closed portfolio should not be limited to prepayable financial assets to be eligible for the portfolio layer method; however, the Committee has different views on how far to extend eligibility. Certain members of the Committee believe that the scope of the portfolio layer method should be extended to nonprepayable debt instruments that are of high credit quality and that are non-amortizing such as US Treasury Securities.



Other members of the Committee note that the portfolio layer method allows for the application of hedge accounting to a stated notional amount that is expected to both 1) experience changes in fair value with changes in the identified benchmark interest rate and 2) remain outstanding through a specified maturity date. These Committee members note that these characteristics also exist in a held portfolio that includes both prepayable and nonprepayable debt instruments. Though the single-layer method was initially established to address the complexities associated with applying hedge accounting to prepayable financial assets, these Committee members believe that there is no conceptual basis for limiting this strategy to such assets.

Many asset classes that do not qualify as prepayable are subject to default risk by the borrower. Defaults are similar to prepayments in that they are not controlled by the entity looking to hedge interest rate risk and a high amount of uncertainty exists regarding which assets within a portfolio will default. Additionally, certain beneficial interests that are supported by a portfolio of assets may receive protection from default risk such that defaults are treated as a paydown or involuntary prepayment of the beneficial interest. In either case, the potential for default by the borrower creates uncertainty in the cash flows of the instrument and this uncertainty affects an entity's ability to construct an effective hedge. The Board acknowledged this uncertainty in its initial creation of the portfolio layer strategy for prepayable assets as it allowed both prepayments and defaults to be excluded from the layer of the closed portfolio that is designated as the hedged item.

Committee members note per BC116 of ASU 2017-12 that the Board's primary purpose for establishing the portfolio layer method was to provide entities with the ability to obtain hedge accounting for portfolios of prepayable assets without having to incorporate the risks arising from prepayments, defaults and other factors affecting the timing and amount of cash flows into the measurement of the hedged item. We also observe that the high level of uncertainty about which assets within the portfolio would actually prepay was a noted factor in the Board's initial approval of the portfolio level method. Due to the risks inherent in nonprepayable assets related to borrower default and the related uncertainty of the timing and amount of cash flows of these instruments, the Committee members believe that the Board's objective should also be extended to portfolios of non-prepayable assets.

Allowing both prepayable and nonprepayable financial assets to be included in the closed portfolio would further simplify hedge accounting for certain entities as it would allow for a single strategy for hedging changes in fair value due to changes in interest rates rather than requiring a separate hedge accounting approach for financial assets that are prepayable from those that are nonprepayable. Many entities construct their derivative portfolios used for economic hedging of interest rate risk to align with the requirements of hedge accounting. Portfolio level hedging is often difficult for nonprepayable assets as the unique characteristics of the individual assets can cause challenges in satisfying the similar assets test. This requires entities to construct more costly, less efficient derivative portfolios to enable hedge accounting relationships with individual or small groups of assets designated as the hedged item. Expanding the scope of the portfolio layer method to nonprepayable debt instruments held would allow entities to better align their hedge accounting strategy with their objectives for economic hedging and would result in increased efficiency and reduced costs in establishing derivative portfolios for interest rate risk management.

The Committee understands that the primary objective of this project on hedge accounting is to clarify and improve certain of the amendments in ASU 2017-12, rather than to broadly reconsider portfolio



hedging. Further, we acknowledge that the existing requirements for a financial asset to qualify as prepayable are not unduly prohibitive and that the portfolio layer method is a beneficial tool as currently established. However, we request the Board consider expanding these benefits to other asset types as either part of this project or as a separate project on the portfolio layer method.

### **Breach Accounting**

The Committee believes that improvements could be made to the Proposed Update for scenarios where a hedge layer is actually breached. These improvements relate to 1) the methodology for determining which layers are dedesignated upon an actual breach and 2) the penalties imposed on entities when an actual breach occurs. Each of these improvements is discussed further below.

#### **1. Methodology for determining which layers are dedesignated upon an actual breach**

The Proposed Update provides guidance in ASC 815-25-40-8(b)(2) on which layers should be dedesignated upon an actual breach in a multiple layer method hedge. This guidance states that “if there are multiple hedged layers at the time of the breach, the entity shall dedesignate the hedged layer with the shortest remaining period until the hedged item’s assumed maturity date that would result in the remaining hedges fully meeting the requirements in paragraph 815-25-35-7A”. However, ASC 815-20-55-14N provides an example of a scenario where multiple hedged layers exist at the time of the breach and the layer that is dedesignated is the layer with the longer remaining period until the hedged item’s assumed maturity date because dedesignation of this layer (the 7-year layer) cures the breach and results in the remaining layer (the 3-year layer) fully meeting the requirements in paragraph 815-25-35-7A. The Committee recommends that the Board clarify in ASC 815-25-40-8(b)(2) that an entity should first identify and dedesignate layers that can unilaterally cure the breach prior to applying the shortest remaining period until assumed maturity methodology if that is the Board’s intent.

Further, we recommend that the Board clarify whether an entity is required to apply the shortest remaining period until assumed maturity methodology in scenarios where dedesignation of multiple layers would cure the breach but dedesignation of a single layer would not. For example, assume three hedged layers exist at the time of the breach and dedesignation of the layers with the 2<sup>nd</sup> longest and 3<sup>rd</sup> longest remaining period until assumed maturity would cure the breach (and the only other combination that would cure the breach is dedesignation of all three layers). In this scenario, the guidance in ASC 815-25-40-8(b)(2) is not clear whether the entity should dedesignate the two layers and maintain the layer with the shortest remaining period until assumed maturity or dedesignate all three layers pursuant to the shortest remaining period until assumed maturity methodology.

If an entity is not required to apply the shortest remaining period to assumed maturity methodology in scenarios where dedesignation of multiple hedged layers would cure the breach, the Committee recommends that the Board clarify the methodology for determining which combination of layers should be dedesignated when multiple combinations would cure the breach. For example, assume four hedged layers exist at the time of the breach and the breach could be cured by either 1) dedesignating the hedged layers with the shortest remaining period until assumed maturity and the longest remaining period until assumed maturity, 2) dedesignating the hedged layers with the 2<sup>nd</sup> shortest remaining period until assumed maturity and the 3<sup>rd</sup> shortest remaining period until assumed maturity or 3) dedesignating the layers with the shortest, 2<sup>nd</sup> shortest and 3<sup>rd</sup> shortest remaining period until assumed maturity. In this scenario, the



guidance in ASC 815-25-40-8(b)(2) is not clear whether the options that result in the dedesignation of only two layers are preferred over the option that results in the dedesignation of three layers. Further, the guidance is not clear whether option 1 would be preferred over option 2. The Committee recommends that the Board clarify in ASC 815-25-40(b)(2) its intent with respect to these scenarios.

The Committee also notes that the shortest remaining period until assumed maturity methodology is not relevant for multiple layer method hedges when the entity has established subgroups and is projecting the portion of the layer that will remain at the assumed maturity of the hedge by subgroup. In this scenario, the subgroup(s) experiencing an actual breach would be known and the hedge relationship(s) related to those subgroup(s) should be dedesignated. Committee members believe that this exception to the accounting for breaches of multiple layer method hedges involving subgroups should be specifically addressed in the accounting guidance.

Committee members also believe that the guidance in the Proposed Update could be improved by allowing an entity to either use the methodology defined by the Board in the Proposed Update or define at the inception of the hedge an alternate methodology for determining which layers would be dedesignated upon a breach. This would allow an entity to consider its own risk management practices and align the hedge strategy to those practices. If an entity did not define the dedesignation process at implementation of the strategy, then the default guidance prescribed in the Proposed Update would be applicable. Specifically, the entity would follow the prescribed guidance in the Proposed Update of dedesignating the hedged layer with the shortest remaining period until the hedged item's assumed maturity date such that the remaining hedges would continue to qualify for portfolio layer method hedging.

## **2. Penalties imposed on entities when an actual breach occurs**

Certain Committee members also disagree with the accounting for actual breaches discussed in the Proposed Update and believe that the accounting for actual breaches should follow the same accounting as anticipated breaches. These Committee members also believe that the penalty for an actual breach (i.e., dedesignation of the entire hedge layer) should be replaced with a programmatic penalty where a pattern of actual breaches would prospectively taint the entity's hedge accounting strategy related to the portfolio layer method. Other members of the Committee agree with the penalties imposed on hedge relationships that experience an actual breach as outlined in the Proposed Update. Each of these alternative views are discussed further below.

### **View A - Aligning the accounting guidance for actual and anticipated breaches**

Upon the occurrence of a breach, the Proposed Update requires that hedge accounting be discontinued for an entire hedged layer(s) until the remaining hedged layer(s) can support the amount of the closed portfolio anticipated to be outstanding for the period hedged. Certain Committee members believe that the requirement to dedesignate hedge relationships in their entirety upon a breach is overly punitive as it may require entities to discontinue hedge accounting on a portion of the hedged item that is anticipated to be outstanding throughout the hedge period. If the same rules that apply to an anticipated breach were applied to an actual breach, the effective portion of the hedge relationship would continue to report the economics of the hedge strategy which will allow for more efficient risk management and better financial reporting.



Dedesignations of the entire hedge relationship upon a breach have punitive impacts to the portion of the hedged item that is expected to be outstanding during the hedge period. These punitive impacts include 1) misalignment of amortization of fair value adjustments related to the hedged item and hedging instrument that occurred prior to the breach and 2) ineffectiveness in redesignated hedge relationships related to the hedging instrument with an inception date fair value other than zero. These punitive impacts are discussed further below.

#### *Misalignment of fair value adjustments*

During a hedge relationship that is highly effective, basis adjustments representing changes in the fair value of the hedged item are generally not amortized into income for accounting purposes. However, these basis adjustments “naturally amortize” through subsequent changes in fair value as the hedged item approaches the assumed maturity of the hedge relationship (i.e., the fair value of the hedged item moves to zero at the assumed maturity of the hedge relationship). The basis adjustments on the hedged item are generally offset by fair value changes on the designated hedging instrument and these fair value amounts also naturally amortize over the life of the hedging instrument (i.e., the fair value of the hedging instrument moves to zero at maturity). Further, because the assumed maturity of the hedged item and the maturity of the hedging instrument are substantially aligned, the natural amortization of fair value adjustments on the hedged item and the hedging instrument will generally offset while the hedge relationship is highly effective.

When a hedge relationship is dedesignated, basis adjustments associated with the hedged item are no longer “naturally amortized” through the assumed maturity of the hedge relationship via subsequent fair value adjustments. Instead, these basis adjustments, including those related to the amount of the hedged item that is anticipated to be outstanding through the hedge period, are allocated to the assets in the closed portfolio and amortized over a period that is consistent with the amortization of other premiums and discounts associated with the respective assets. In a partial term hedge, this amortization period could be longer than the period that remains on the hedge relationship. This results in a misalignment between the amortization of fair value adjustments on the hedged item and the hedging instrument, the latter of which continue to be naturally amortized over the life of the hedging instrument. Permitting partial dedesignations of hedge relationships upon a breach similar to those permitted for anticipated breaches will allow entities to preserve the alignment of amortization for that portion of the hedged item that is anticipated to be outstanding during the hedge period.

#### *Ineffectiveness in redesignated hedge relationships*

If a hedge relationship is required to be dedesignated in its entirety, entities will likely redesignate a new layer in the same closed portfolio for that portion of the hedged item that is expected to be outstanding during the hedge period. Further, the derivative associated with the dedesignated hedge relationship will likely be partially closed-out and redesignated as the hedging instrument in the new hedged layer. The derivative will have a fair value other than zero at the inception of the redesignated hedge relationship as a result of fair value changes occurring prior to the breach. This inception date fair value will naturally amortize to zero over the life of the hedging instrument. This natural amortization will cause ineffectiveness in the hedge relationship as the hedged item will be presumed to have an inception date fair value of zero and will have no corresponding amortization. Further, the inception date fair value of the hedging instrument could be so large



such that it cannot be designated in a highly effective hedge relationship. In this scenario, an entity would be required to close out the original derivative and enter into a new at market derivative, which may have negative economic consequences.

If the same rules that apply to anticipated breaches were applied to an actual breach, only a portion of a layer would likely be dedesignated and the effective portion of the hedge relationship would continue to report the economics of the hedge strategy, i.e., the hedged layer would be reported at the benchmark variable rate without the noise created from having to dedesignate and redesignate an entire layer.

Committee members supporting this view acknowledge that the Board desires to discourage aggressive estimates related to the amount of the closed portfolio anticipated to be outstanding and that the punitive accounting in the Proposed Update serves as an impediment to such estimates. However, these Committee members note that a breach may be the result of an event or events that could not have been reasonably foreseen by the entity when the closed portfolio was constructed and believe that an entity should not be penalized in such circumstances. As an alternative, these Committee members believe that a deterrent similar to that outlined in ASC 815-30-40-5 for cash flow hedges on forecasted transactions will adequately discourage entities from aggressively predicting the portion of a closed portfolio that is expected to be outstanding as of the assumed maturity of the hedge relationship. Specifically, if an entity displays a pattern of actually breaching a layer, that pattern should call into question both an entity's ability to accurately predict a stated amount or stated amounts of a closed portfolio of prepayable financial assets (or one or more beneficial interests secured by a portfolio of prepayable financial instruments) that is not expected to be affected by prepayments, defaults, or other factors affecting the timing and amount of cash flows for the period hedged and the propriety of using hedge accounting in the future for similar hedged transactions. Under this approach, rare events that result in a breach but that could not have been reasonably foreseen by the entity would not impact that entity's ability to prospectively apply the portfolio layer method.

An important component of implementing the Proposed Update will be employing the right level of controls and processes to monitor the closed portfolios and their behavior to ensure the amount of a closed portfolio that is being hedged continues to be supported by an entity's expectations regarding prepayments, defaults, or other factors affecting the timing and amount of cash flows over the hedge period. With the proper level of controls and processes, Committee members believe that actual breaches would result in only isolated, nonrecurring, and unusual occurrences that could not have been reasonably anticipated. Because this would be limited in occurrence, Committee members believe that allowing the same rules that apply to both anticipated and actual breaches will allow entities to react to the changing environment without the negative consequences of allocating the basis adjustment not associated with the breach to the remaining individual assets in the closed portfolio.

*View B - Dedesignating hedge relationships in their entirety upon a breach*

Other members of the Committee acknowledge that entities are required to periodically resize hedge relationships from anticipated breaches based on a reasonable process that supports their estimate of events that may impact the timing of cash flows on the closed portfolio. As such, actual breaches are the result of events that were not otherwise anticipated based on good faith estimates. Consequently, these Committee members do not support a programmatic penalty that would require entities to prospectively delink their accounting from their economic strategy related to interest rate risk management. These



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Committee members agree with the Board’s conclusion to exclude a tainting threshold from the portfolio layer method and believe that the breach accounting that has been established in the Proposed Update (i.e., the dedesignation of the entire hedge layer) represents a reasonable penalty for unsuccessfully forecasting events that may impact the timing of cash flows on the hedged item when such forecasts are based on good faith estimates.

**Follow the Asset Method**

The Committee does not believe that entities should be required to use the proposed follow the asset method in accounting for an actual breach that requires entities to identify the most recent transaction that caused the breach to determine whether the basis adjustment associated with the breach is recognized in interest income or credit expense. We are not aware of any conceptual basis for having the most recent transaction determine the accounting presentation in these circumstances. For example, a closed portfolio may experience defaults that are consistent with expectations while experiencing significantly higher prepayment activity than anticipated when the portfolio layer hedge relationship was established. In this scenario, we do not believe that an entity should be required to record the basis adjustment through credit loss expense simply because the actual event that caused the breach was a default. Additionally, actual breaches of the portfolio should be rare events and we do not believe that the incremental accounting processes necessary to adopt this guidance is justified. We believe that the presentation of the basis adjustment associated with the breach should be an accounting policy election that would provide entities flexibility to recognize these basis adjustments in interest income, credit expense or an alternative rationale method.

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We appreciate the opportunity to provide comments on the Proposed Update and would be pleased to discuss our comments with the FASB or its staff at your convenience.

Sincerely,

A handwritten signature in blue ink that reads "N. Schroeder". The signature is written in a cursive, flowing style.

Nancy J. Schroeder, CPA  
Chair, Financial Reporting Committee  
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