FASB issues ASU

Fair value hedging – portfolio-layer method

March 29, 2022

A new ASU expands fair value hedge accounting for financial assets in a closed portfolio.

Applicability

ASU 2022-01, Fair Value Hedging – Portfolio Layer Method

Applies to all entities that elect to apply the portfolio-layer method of hedge accounting in Topic 815.

Fast facts, impacts, actions

ASU 2022-01 establishes the portfolio-layer method, which expands an entity's ability to achieve fair value hedge accounting for hedges of financial assets in a closed portfolio. The ASU's primary provisions:

— allow non-prepayable financial assets to be included in the closed portfolio;

— expand the current single-layer model to allow multiple hedged layers of a single closed portfolio;

— clarify that fair value basis adjustments in an existing portfolio layer method hedge are maintained at the closed portfolio level (i.e. not allocated to individual assets);

— prohibit an entity from considering fair value basis adjustments related to a portfolio-layer method hedge when estimating credit losses;

— address how an entity accounts for fair value basis adjustments when discontinuing a portfolio-layer method hedge;

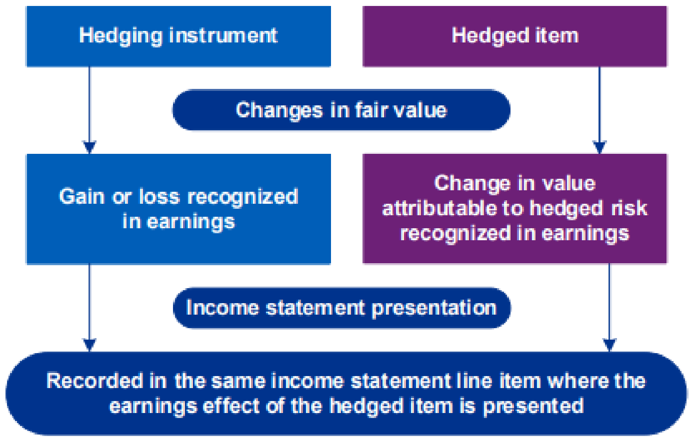
— allow the reclassification of held-to-maturity (HTM) debt securities to available-for-sale (AFS) within 30 days of the date of adoption, if certain criteria are met.

If an entity has adopted ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities, it may early adopt ASU 2022-01 (see Effective dates and transition) on any date on or after the issuance of the ASU.

> **Action:** Portfolio-layer method hedging allows entities to achieve fair value hedge accounting for a greater proportion of the interest rate risk inherent in a closed portfolio of financial assets. Entities that are economically hedging closed portfolios as part of their risk management strategy should consider whether those economic hedges would qualify for hedge accounting under this guidance.

Background

The objective of a fair value hedge is to reduce or eliminate exposure to a change in the fair value associated with a specific item (hedged item) due to a particular risk (hedged risk). If the relationship between the derivative instrument and hedged item meets the hedging requirements in Topic 815, the changes in fair value are accounted for as follows.



Topic 815 currently permits entities to hedge a single layer of a closed portfolio of prepayable financial assets. Under this approach, an entity designates a fixed amount of the portfolio as the hedged item in a fair value hedge of interest rate risk if it expects that the designated amount will remain outstanding at the end of the hedge term.

Example 1: Single-layer hedge of a single closed portfolio

An entity has a $1 billion closed portfolio of 15-year prepayable mortgage loans and expects that $250 million will remain outstanding at the end of 10 years. The entity may designate up to a $250 million portion of the mortgage portfolio as the hedged item in a fair value hedge of interest rate risk for 10 years.

The entity performs and documents an analysis supporting its expectation that the hedged layer (i.e. the hedged item) will remain outstanding at the end of the hedge term. This is done as part of the initial hedge documentation and on each effectiveness assessment date. The analysis incorporates the entity's current expectations of prepayments, defaults and other factors affecting the timing and amount of cash flows associated with the closed portfolio of financial assets.

Because the $250 million hedged amount is expected to remain outstanding at the end of 10 years, the entity does not consider prepayment risk when assessing hedge effectiveness and measuring the change in fair value of that portion of the mortgage portfolio attributable to interest rate risk.

Prior to ASU 2022-01, stakeholders requested the FASB:

- allow multiple-layer hedging strategies in a single closed portfolio; and
- provide additional guidance on how to account for and disclose fair value basis adjustments of existing hedges of closed portfolios.

ASU 2022-01 addresses the above items as well as other implementation issues raised by stakeholders.

Scope

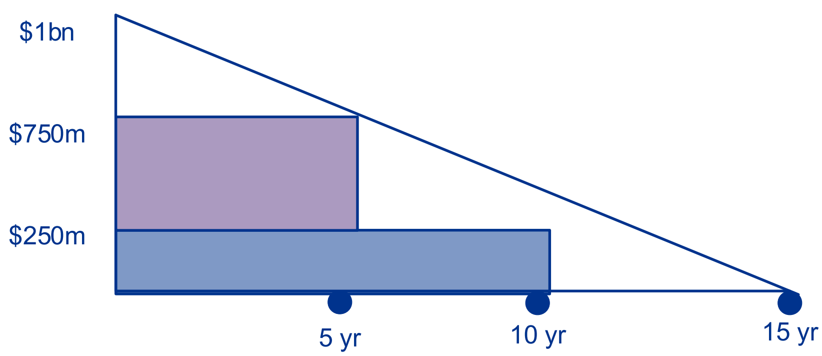
The ASU establishes the portfolio-layer method of hedge accounting, which allows fair value hedging of multiple hedged layers of single closed portfolios of prepayable and non-prepayable financial assets. Before adopting the ASU, an entity is only permitted to hedge a single-layer of a closed portfolio of prepayable financial assets.

The following illustrates one approach an entity may use to hedge multiple layers.

Example 2: Multiple hedged layers of a single closed portfolio

Consistent with example 1, an entity has a $1 billion closed portfolio of 15-year mortgage loans and has previously designated a hedging relationship with $250 million of the portfolio expected to be outstanding at the end of ten years as the hedged item. The entity wants to add a second hedged layer and designates a separate hedging relationship with $500 million of the portfolio expected to be outstanding at the end of five years as the hedged item.

The entity performs and documents an analysis supporting its expectation that the hedged layers (i.e. the hedged items) for both hedging relationships will remain outstanding at the end of the hedge terms. This is done as part of the initial hedge documentation and on each effectiveness assessment date. The analysis incorporates the entity's current expectations of prepayments, defaults and other factors affecting the timing and amount of cash flows associated with the closed portfolio of financial assets.



Accounting for basis adjustments and dedesignations

The amortized cost basis of a hedged item in a fair value hedge is adjusted for its change in fair value that is attributable to the risk being hedged. This adjustment is referred to as a basis adjustment. The ASU clarifies that the basis adjustment in an existing portfolio-layer method hedge is maintained at the balance sheet line item level, and is therefore not allocated to individual assets. In addition, because the hedged layer is not expected to be affected by defaults, an entity does not consider basis adjustments in an existing hedge when estimating credit losses.

If the amount of the hedged layer(s) is anticipated to exceed the amount of the closed portfolio for the designated hedge period, but has not exceeded it yet (i.e. a breach is anticipated in the future), an entity:

- discontinues or partially discontinues hedge accounting for one or more hedging relationships for the portion of the hedged item that is no longer anticipated to be outstanding for the designated hedge period;
- allocates the basis adjustment related to the discontinued relationships to the remaining individual assets in the closed portfolio that supported the hedged layer using a systemic and rational method; and

- amortizes those amounts over a period consistent with discounts or premiums associated with the respective assets.

If the amount of the hedged layer(s) exceeds the amount of the closed portfolio (i.e. a breach has occurred), an entity:

- discontinues or partially discontinues hedge accounting for one or more hedging relationships for the portion of the hedged item that is no longer outstanding;
- determines the portion of the basis adjustment associated with the breach using a systemic and rational method; and
- immediately recognizes the basis adjustment associated with the breach in interest income.

Effective dates and transition

	Public business entities	Other entities
Annual periods – Fiscal years beginning after	December 15, 2022	December 15, 2023
Interim periods – In year of adoption	Yes	Yes
Early adoption permitted?	Yes. Early adoption is permitted on any date on or after the issuance of ASU 2022-01 for any entity that has adopted ASU 2017-12.	
Transition requirements	— Adjustments to the fair value basis adjustments are applied on a modified retrospective basis by recording a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. — An entity applies the guidance for designating more than one portfolio-layer method hedging relationship for a single closed portfolio on a prospective basis.	

Reclassification of debt securities from HTM to AFS

Under the transition provisions of ASU 2022-01, an entity may reclassify debt securities that were classified as HTM immediately before the date of adoption of ASU 2022-01 to AFS. However, the reclassification must be made within 30 days of the adoption of ASU 2022-01 and the reclassified debt securities must be included in a closed portfolio that is designated in a portfolio-layer method hedge within that same time period. The related financial statement effects are recognized at the date the reclassification is made, as opposed to the date of adoption.

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