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FASB Clarifies Hedge Accounting Guidance

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Introduction

On March 28, 2022, the FASB issued [ASU 2022-01](#),¹ which clarifies the guidance in ASC 815² on fair value hedge accounting of interest rate risk for portfolios of financial assets. The ASU amends the guidance in [ASU 2017-12](#)³ (released on August 28, 2017) that, among other things, established the “last-of-layer” method for making the fair value hedge accounting for these portfolios more accessible. ASU 2022-01 renames that method the “portfolio layer” method and addresses feedback from stakeholders regarding its application.

The FASB’s objectives in issuing ASU 2017-12 were to better align an entity’s financial reporting with the results of its risk management strategy and to improve the hedge accounting model by simplifying it. To that end, the Board also issued a [proposed ASU](#)⁴ on November 12, 2019, that would clarify certain amendments made by ASU 2017-12; however, those are unrelated to portfolio fair value hedge accounting. The proposal has not yet been finalized. (For more information about the proposal, see Deloitte’s November 26, 2019, [Heads Up](#).)

The main provisions, effective dates, and transition requirements of ASU 2022-01 are discussed below.

¹ FASB Accounting Standards Update (ASU) No. 2022-01, *Fair Value Hedging — Portfolio Layer Method*.

² FASB Accounting Standards Codification (ASC) Topic 815, *Derivatives and Hedging*.

³ FASB Accounting Standards Update No. 2017-12, *Targeted Improvements to Accounting for Hedging Activities*.

⁴ FASB Proposed Accounting Standards Update, *Codification Improvements to Hedge Accounting*.

Main Provisions of ASU 2022-01

Scope

Under current guidance, the last-of-layer method enables an entity to apply fair value hedging to a stated amount of a closed portfolio of prepayable financial assets (or one or more beneficial interests secured by a portfolio of prepayable financial instruments) without having to consider prepayment risk or credit risk when measuring those assets. ASU 2022-01 expands the scope of this guidance to allow entities to apply the portfolio layer method to portfolios of all financial assets, including both prepayable and nonprepayable financial assets. This scope expansion is consistent with the FASB's efforts to simplify hedge accounting and allows entities to apply the same method to similar hedging strategies.

Multiple-Layer Hedges of a Single Closed Portfolio

Entities that apply the last-of-layer method designate, as the hedged item in a fair value hedge of interest rate risk, a stated amount of the asset or assets that are not expected to be affected by prepayments, defaults, or other factors influencing the timing or amount of cash flows. The hedged item represents a single layer in the closed portfolio. ASU 2022-01 expands the current model to explicitly allow entities to designate multiple layers in a single portfolio as individual hedged items. This allows entities to designate multiple hedging relationships with a single closed portfolio, and therefore a larger portion of the interest rate risk associated with such a portfolio is eligible to be hedged. Multiple-layer hedges are not addressed under current guidance.

ASU 2022-01 also addresses questions about the types of derivatives that could be used as the hedging instrument in potential multiple-layer hedges. Under the ASU, an entity has the flexibility to use any type of derivative or combination of derivatives (e.g., spot-starting constant-notional swaps with different term lengths, a combination of spot-starting and forward-starting constant-notional swaps, amortizing-notional swaps) by applying the multiple-layer model that aligns with its risk management strategy.

In its guidance on multiple-layer hedges of a single closed portfolio, the ASU also clarifies that no assets may be added to a closed portfolio once it is designated in a portfolio layer method hedge. However, at any time after the initial hedge designation, new hedging relationships associated with the portfolio may be designated and existing hedging relationships associated with the portfolio may be dedesignated to align with an entity's evolving strategy for managing interest rate risk on a timely basis.

In a manner consistent with the guidance established by ASU 2017-12 on single-layer hedges, ASU 2022-01 requires an entity to perform a documented analysis in each period to support an expectation that the aggregate amount of the multiple hedged items (i.e., the hedged layers) will be outstanding for the periods hedged. ASU 2022-01 also requires the partial or full dedesignation of a hedged layer or layers upon an anticipated or actual breach (i.e., when the aggregate amount of the hedged layers exceeds the amount of the closed portfolio). In either case, the ASU requires an entity to determine which layer or layers to dedesignate or partially dedesignate in accordance with its entity-wide accounting policy election that specifies a systematic and rational approach for making such a determination.

Accounting for Hedge Basis Adjustments Under the Portfolio Layer Method

ASU 2022-01 expands and clarifies the current guidance on accounting for fair value hedge basis adjustments under the portfolio layer method for both single-layer and multiple-layer hedges.

As it would for any other fair value hedge, an entity should adjust the basis of the hedged item for the change in fair value that is attributable to changes in the hedged risk (i.e., interest rate risk) as of each reporting date. However, the hedged item (i.e., the hedged layer) in a portfolio layer method hedge is related to multiple assets within a closed portfolio, but it is not necessarily related to all of the assets within that portfolio. Accordingly, ASU 2022-01 clarifies that an entity would adjust the basis at the portfolio level and should not allocate it to individual assets within the portfolio. There is no guidance on such treatment under current requirements.

If assets in a closed portfolio are presented within more than one line item on the balance sheet, ASU 2022-01 requires an entity to use a systematic and rational method to allocate the portfolio-level basis adjustment to the associated line items. However, it also clarifies that the entity should not allocate those adjustments on a more disaggregated basis for any disclosures not otherwise required by ASC 815. Rather, an entity should disclose the total amount of the basis adjustments as a reconciling amount in any affected disclosures. ASU 2022-01 updates the current guidance, which states that the allocation of basis adjustments may be required by other areas of GAAP.

Further, the ASU does not change an entity's current requirement to allocate the portfolio-level basis adjustment to the individual assets within a closed portfolio upon a dedesignation of a hedging relationship. The entity must, however, (1) recognize the reversal of all basis adjustments associated with a breach in interest income and (2) disclose the specific amount and cause of the breach.

ASU 2022-01 also provides guidance on the relationship between the portfolio layer method requirements and other areas of GAAP. It addresses questions raised by stakeholders about the interaction between the last-of-layer method guidance and ASC 326⁵ or other impairment guidance (for entities that have not yet adopted ASC 326) by explicitly prohibiting entities from considering basis adjustments related to existing portfolio layer method hedges when measuring credit losses on the assets included in the closed portfolio.

Effective Dates and Transition

Effective Dates

ASU 2022-01's amendments are effective as follows:

- For public business entities, fiscal years beginning after December 15, 2022, and interim periods within those fiscal years.
- For all other entities, fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.

The guidance may be early adopted if an entity has adopted ASU 2017-12 for the corresponding period.

⁵ FASB Accounting Standards Codification Topic 326, *Financial Instruments — Credit Losses*.

Transition

An entity that elects a multiple-layer hedging strategy should apply ASU 2022-01's requirements prospectively. Further, aside from the disclosure requirements in other areas of GAAP, an entity should apply the amendments related to the fair value hedge basis adjustments under the portfolio layer method on a modified retrospective basis by making a cumulative-effect adjustment to the opening balance of retained earnings. An entity may choose to apply the other GAAP disclosure requirements prospectively or retrospectively.

In addition, as of the adoption date, an entity may reclassify debt securities that qualify as being in a portfolio layer hedging relationship from the held-to-maturity category to the available-for-sale category if the entity intends to include those securities in a portfolio designated in a portfolio layer method hedge. An entity must determine which securities to reclassify within 30 days of the adoption date of the ASU and must include those reclassified securities within a portfolio layer method hedging relationship within those 30 days.

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