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July 6, 2021

Via email to director@fasb.org

Ms. Hillary Salo, Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Derivatives and Hedging (Topic 815): Fair Value Hedging—Portfolio Layer Method (File Reference No. 2021-002)

Dear Ms. Salo:

We are pleased to provide comments on the Board's proposal to expand and clarify the last of layer method for fair value hedges.

While we support the Board's objective of expanding the standard to better portray the economic results of an entity's risk management activities in its financial statements, we have concerns regarding the application of certain matters, including identifying the source of a breach and prescriptive basis adjustments. We have offered some suggestions in our detailed responses that we believe will help to achieve the Board's objectives. Our detailed responses to the Questions for Respondents are contained in the attached Appendix.

We would be pleased to discuss our comments with the FASB staff. Please direct questions to Gautam Goswami at (312) 616-4631 or Tim Kviz at (703) 245-8685.

Very truly yours,

BDO USA, LLP

BDO USA, LLP

Appendix

Question 1: Are the amendments in this proposed Update operable and auditable? If not, which proposed amendment or amendments pose operability and auditability issues?

We believe that certain of the amendments in this proposed update may not be operable and auditable without undue cost and effort, particularly with respect to the prescriptive guidance related to basis adjustments.

The principle behind the portfolio layer approach is not based on hedging specific loans or other assets, but rather hedging the cash flows generated by a closed portfolio of loans that have been constructed into hypothetical tranches of bullet debt, or layers. Once these hypothetical tranches have been created, the specific nature of the loans that comprise the hypothetical tranche lose their individual character and they simply become a pool of fungible cash flows. The proposal specifies the level at which to account for basis adjustments, but this appears inconsistent with that underlying principle.

We agree that the proposed update should provide guidance on when, and the period over which, basis adjustments be amortized. But, we believe that entities should be allowed to determine the level at which this should be applied. Different organizations have different systems with various degrees of complexity. Some may have robust systems that are able to capture and amortize (when necessary) basis adjustments at various levels (i.e., pool or individual asset), whereas others may have limits.

Additionally, identifying the nature of the cause of a breach to determine where basis adjustments should be recognized in the income statement may not be practical. With prepayable securities, we believe it may be difficult to determine the nature of a prepayment related to a security (i.e., interest rate related vs credit related) without looking through to the loans underlying the security, and this information may not be available to the holder of the security. With respect to prepayable loans, it is possible, and quite likely, that closed pools will experience prepayments due to both interest related changes and credit related changes. Further, the closed pool of loans will likely exceed the hedged layer(s). We believe it may be difficult to identify the nature of the prepayments that caused the breach to classify the basis adjustment in the income statement as either interest income or as a credit loss, as required by the proposal. We are also not convinced that the costs of doing so are justified. Further, as stated above, this notion may be inconsistent with the principle of the portfolio layer approach that an entity is hedging a hypothetical tranche of fungible cash flows generated by the pool of underlying assets. It may be impractical for entities to identify and independent accountants to audit the nature of the prepayment, as the hedge relationship is not related to individual assets.

Question 2: As proposed, would the multiple-layer model align with the entities risk management objectives? Please explain why or why not.

Yes, in certain circumstances. We believe the proposed multiple layer model may align with the entities risk management objectives related to securities, because it allows entities to maximize the amount of principal expected to be outstanding over multiple periods that can be hedged rather than hedging only the amount the entity expects to be outstanding at a single point in time. Further, securities themselves are a fixed unit of account that does not change over time, and the loans that underly the security remain in the pool. However, when hedging prepayable loans, since it can only be applied to closed pools, we believe the proposed Update may not provide the intended benefit. While an entity could still apply the portfolio layer approach to a closed pool for prepayable loans, we believe many organizations will need to frequently dedesignate and re-designate hedge relationships, as risk management focuses more on open pools, rather than a closed pool of loans.

The proposal indicates that an entity would need to determine at each subsequent effectiveness assessment date whether the assets in a closed portfolio with multiple hedged layers continue to meet the contractual maturity and prepayment criteria. To be consistent with the rest of the paragraph 815-25-35-7A, we suggest that the Board specify that determination needs to be formally documented.

Question 3: Do you agree with the Board's decision to limit the scope of the types of instruments eligible for the portfolio layer method hedging to prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments? Please explain why or why not.

We agree with the Board's decision and basis for conclusions in this regard.

Question 4: Do you agree with the Board's proposed amendments on hedge dedesignation sequencing under the multiple-layer model? Please explain why or why not.

Yes, we agree with the proposed amendments on hedge de-designation sequencing under the multiple-layer model.

Question 5: Do you agree with the Board's proposed amendments on accounting for basis adjustments and disclosure of those basis adjustments in disclosures required by other areas of GAAP outside hedge accounting? Please explain why or why not?

We agree with the proposed amendments on the disclosure of basis adjustments. However, in accounting for basis adjustments, we believe the proposal should limit the guidance to when and the period over which basis adjustments should be amortized. We believe the proposal should provide entities with the flexibility to determine how to allocate remaining basis adjustments (i.e., at the closed pool level, or at the individual loan level using a systematic and rational method) based on their internal system capabilities, processes, and internal controls. The proposal, as currently drafted, provides prescriptive guidance on how basis adjustments should be allocated. We believe this is an operational matter that is best addressed by entities and their independent accountants. Also see our responses to Question 6.

Question 6: In the case of a breach, do the expected costs of identifying which assets in the closed portfolio that caused the breach justify the expected benefits of aligning the derecognition guidance with other Topics in GAAP? Please explain why or why not.

We do not believe the expected costs of identifying which assets in the closed portfolio that caused the breach justify the expected benefits. Because the portfolio layer method is not based on hedging individual loans, but rather the fungible cash flows generated by the underlying loans in a closed pool that is larger than the hedged layers, the individual loans lose their character. The hedge relationship is hedging a stream of hypothetical cash flows.

The requirement to account for basis adjustments at the closed pool level until a breach occurs, combined with the requirement to identify which assets in the closed portfolio caused the breach, is essentially combining two different units of account – the closed pool prior to the breach and the individual loans after a breach. We believe this may be complex for some organizations to determine how to navigate between these two units of account. Additionally, it may result in basis adjustments only being attributed to a subgroup of some of the loans in the closed pool, despite the fact that the hedged layers are constructed, after considering the aggregate anticipated cash flows of all of the loans in the closed pool, and not just the subgroup related to the breached layer. It will also be helpful if the Board more clearly explain why the concept of a subgroup, as illustrated in paragraph 815-40-55-14H, within an already closed pool is necessary as that appears to introduce unnecessary complexity.

If an entity were permitted to allocate basis adjustments to the individual loans in the closed pool, basis adjustments attributed to performing loans would then be amortized over their remaining life whereas basis adjustments attributed to loans that prepay (or partially prepay) could be identified for recognition in interest income. And basis adjustments attributed to loans that defaulted could be better identified for inclusion on the measurement of a credit loss. With this approach, the basis adjustments are always accounted for using the same unit of account – the individual loan level. Further, recognition of the basis adjustments in the income statement would be consistent with the proposal (i.e., prepayment in interest income and loss events in credit losses) without the need to first, all of a sudden, identify which loans caused the breach, and then try to determine whether that was due to prepayment or a credit default as required by the proposal. To clarify, we are not suggesting mandating basis adjustments at the individual loan level but provide entities the option to do so, also noting that many entities that avail the portfolio layer hedging strategy may have robust processes, systems and strategies that allow for individual identification.

Mortgage-backed securities holders are provided information about prepayments on the loans underlying the securities, but do not distinguish between voluntary prepayments (i.e., generally interest rate related) or involuntary prepayments (i.e., removal from the pool due to credit events). As a result, we do not believe it is practical to identify which assets caused the breach. Consequently, we believe that entities should account for portfolio layer hedge accounting basis adjustments for securities in interest income consistent with the general guidance followed for basis adjustments in fair value hedge accounting of interest rate risk.

Question 7: Would any of the proposed amendments require special consideration for private companies that are not financial institutions and not for profit entities (except for not-for-profit entities that have issued, or are conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over the counter market)? If so, which proposed amendment or amendments would require special consideration and why?

No, we do not believe any of the proposed amendments would require special consideration for private companies that are not financial institutions and not for profit entities.

Question 8: Do you agree with the proposed transition guidance? Please explain why or why not.

Yes, we agree with the proposed transition guidance. We suggest that the Board confirm whether entities that had earlier reclassified certain debt securities from the held-to-maturity category to available-for-sale upon adoption of ASU 2017-12[1] would be permitted to avail that accommodation again for any outstanding debt securities, as indicated in the transition section of this proposed update.

Question 9: How much time would be needed to implement the proposed amendments? Should the amount of time needed to implement the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities? Please explain your response.

Entities are not required to use this approach to hedging, and hedge accounting itself is elective. As a result, we do not believe time to implement is of concern. We believe that entities should be allowed to adopt this guidance upon issuance.

[1] Targeted Improvements to Accounting for Hedging Activities