BDO BULLETIN

FAIR VALUE HEDGING: PORTFOLIO LAYER METHOD

APRIL 2022

SUMMARY

The FASB issued ASU 2022-01[1] (the "ASU") to allow non-prepayable financial assets to be included in a closed portfolio[2] hedge using the portfolio layer method, rather than only prepayable assets. It also allows entities to hedge multiple layers rather than just a single layer of a closed portfolio of financial assets (loans) or one or more beneficial interests secured by a portfolio of financial instruments (asset-backed debt securities). The ASU is effective for public entities in fiscal years starting after December 15, 2022 and all other entities have an additional year. Early adoption is permitted for any entity that has adopted the amendments in ASU 2017-12[3] for the corresponding period.

BACKGROUND

A fair value hedge protects an entity from changes in the value of recognized assets, liabilities, and unrecognized firm commitments that are attributable to a particular risk. For example, an entity with a fixed-rate loan may hedge against changes in fair value of the loan due to changes in the benchmark interest rate over the term of that loan.

Under existing guidance in ASC 815, the "last-of-layer" method permits an entity to designate the portion of a closed portfolio of prepayable financial assets that is expected to be outstanding for the designated hedge period as the hedged item in a fair value hedge.[4] Also, the last-of-layer method permits only a single hedged layer (that is, one hedging relationship associated with a closed portfolio). Although applicable to other prepayable assets, the last-of-layer model was designed with a focus on mortgage loans or mortgage-backed securities.

MAIN PROVISIONS

The ASU expands the scope of the last-of-layer method (which has been renamed the "portfolio layer" method) to allow all financial assets to be included in a hedged closed portfolio. This means an entity can apply the portfolio layer method to closed portfolios of prepayable and/or non-prepayable financial assets.

The ASU also allows entities to designate hedges of multiple layers in a closed portfolio of financial assets or one or more beneficial interests if certain criteria are met. The entity will be required to perform and document an analysis

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[1] *Derivatives and Hedging (Topic 815), Fair Value Hedging—Portfolio Layer Method*

[2] While assets may be removed from the portfolio because of prepayments, defaults, sales, and reclassifications, new assets may not be added to a closed portfolio.

[3] In 2017, the FASB issued ASU 2017-12 to introduce the last-of-layer approach for hedging closed portfolios of prepayable financial assets.

[4] ASC 815-20-25-12A

supporting its expectation that the hedged items will be outstanding for the hedge periods at hedge inception and each subsequent assessment date. This will involve an assessment of whether sufficient assets remain in the closed portfolio to support all outstanding hedged layers in aggregate.

The ASU also provides additional guidance on accounting for fair value hedge basis adjustments associated with portfolio layer method hedges. Generally, the change in fair value of the hedged item attributable to the hedge risk in existing portfolio layer hedges does not adjust the carrying value of the individual assets or beneficial interest(s) in or removed from the closed portfolio. Rather, these amounts will be required to be maintained on a closed portfolio basis.

See Appendix A for a summary of the significant amendments included in the ASU.

EFFECTIVE DATES AND TRANSITION

The ASU is effective for public companies in fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. Early adoption is permitted on any date on or after the issuance of this ASU for any entity that has adopted the amendments in ASU 2017-12 for the corresponding period.

The ASU will be applied using the following transition methods:

AREA OF UPDATE	TRANSITION METHOD
Hedging multiple layers in a closed portfolio	Prospective
Accounting for fair value basis adjustments	Modified retrospective basis[5]
Disclosure of fair value basis adjustments	Prospectively or retrospectively

Furthermore, an entity may reclassify debt securities from held to maturity to available for sale if it includes them in a closed portfolio that is hedged under the portfolio layer method. The entity has 30 days after the date of adoption to reclassify debt securities and include them in a hedged closed portfolio.

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The ASU is available **here**

[5] If an entity had allocated the fair value basis adjustment in a last-of-layer hedge to the individual assets in the closed portfolio before adopting the guidance, it would reverse the effect of this allocation through a cumulative-effect adjustment to the opening balance of retained earnings as of the date of adoption.

APPENDIX A

<table>
<tr><th colspan="3">SIGNIFICANT AMENDMENTS TO THE PORTFOLIO LAYER METHOD</th></tr>
<tr><td>Scope</td><td colspan="2">Expands application of the portfolio layer method to non-prepayable financial assets.</td></tr>
<tr><td>Multiple Hedged Layers</td><td colspan="2">Allows designation of multiple layers in a single closed portfolio of financial assets (or one or more beneficial interests secured by a portfolio of financial instruments) as individual hedged items.</td></tr>
<tr><td>Partial-term Hedge</td><td colspan="2">Allows the assumed maturity date of a hedged item to be at the end of the designated hedge period (which does not need to be a contractual coupon payment date).</td></tr>
<tr><td>Eligibility of Hedged Items</td><td colspan="2">Permits designation of new hedging relationships and de-designation of existing hedging relationships associated with the closed portfolio any time after the closed portfolio’s initial hedge designation.</td></tr>
<tr><td>Types of Hedging Instruments and Layering Techniques</td><td>Permits use of different types of derivatives and layering techniques that best align with an entity’s individual circumstances (for example, spot-starting swaps, forward-starting swaps, or a combination of both).</td><td>The ASU clarifies that if an entity is hedging multiple amounts in a closed portfolio with a single amortizing-notional swap, it is required to designate the hedge as a single-layer hedge, not hedges of multiple layers.</td></tr>
<tr><td>De-designation</td><td>If a breach (as defined below) has not occurred and one is not anticipated:
▶ An entity is allowed to fully or partially de-designate any hedge associated with the closed portfolio at any time.
If a breach is anticipated (i.e., the aggregate amount of the hedged layers is no longer anticipated to be outstanding in future hedged periods):
▶ An entity is required to partially or fully de-designate a hedged layer or layers until a breach is no longer anticipated.
If a breach has occurred (i.e., the aggregate amount of the hedged layers currently exceeds the amount of the closed portfolio):
▶ An entity is required to partially or fully de-designate a hedged layer or layers until the aggregate amount of the hedged layers no longer exceeds the closed portfolio.</td><td>The ASU requires an entity that hedges multiple layers to establish an accounting policy (no later than (i) when it first anticipates a breach or (ii) when a breach has occurred) that specifies a systematic and rational approach to determining which hedge or hedges to de-designate (or partially de-designate). Such policy should be consistently applied.</td></tr>
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SIGNIFICANT AMENDMENTS TO THE PORTFOLIO LAYER METHOD		
HEDGE BASIS ADJUSTMENTS		
Allocation to Individual Assets in an Existing Hedge	Prohibits allocating basis adjustments during an existing hedge either to the individual assets in the closed portfolio or to assets removed from the closed portfolio (for example, through prepayment, default, or voluntary sale or reclassification out of the closed portfolio).	
Portion Associated with a Breach	Requires the reversal of the basis adjustment associated with a breached amount to be immediately recognized in interest income.	An entity is required to disclose the following: ▶ The amount of the hedge basis adjustment recognized in current-period interest income because of the breach ▶ The circumstances that led to the breach.
Determining the Portion Attributable to the Hedged Risk Associated with the Available-for-Sale (AFS) Debt Securities	If a closed portfolio includes AFS debt securities and assets that are not AFS debt securities: ▶ An entity is required to determine the portion of the basis adjustment attributable to the AFS debt securities using a systematic and rational method. That amount is then recognized in earnings each period (rather than in other comprehensive income), but it should not be used to adjust the carrying amount of the individual AFS debt securities in the closed portfolio.	Since the basis adjustment associated with the AFS debt securities does not adjust any individual security's carrying amount while the hedge remains designated, no amount of the hedged layer's basis adjustment would be used to determine the gain or loss on sale if a security is sold.
Interaction with Credit Loss Guidance	Prohibits an entity from considering basis adjustments on existing portfolio layer method hedges when measuring credit losses on the assets included in the closed portfolio.	
Presentation	Prohibits an entity from disclosing the outstanding basis adjustment on a more disaggregated basis than the closed portfolio basis; however: ▶ If the assets included in the same closed portfolio are presented in different line items in the balance sheet, an entity shall allocate the basis adjustment to the assets' associated line items in the balance sheet using a systematic and rational method.	
Other Disclosure Matters	If other Topics require the disclosure of the amortized cost basis of assets included in the closed portfolio on a more disaggregated basis, the entity shall exclude the basis adjustment from the amortized cost basis of those assets.	An entity is required to disclose: ▶ The total amount of the basis adjustment excluded from the amortized cost basis of the assets included in the closed portfolio.