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July 2, 2021

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

RE: Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815) – Fair Value Hedging – Portfolio Layer Method* (File Reference No. 2021-002)

Dear Ms. Salo:

We appreciate the opportunity to comment on the proposed ASU, *Derivatives and Hedging (Topic 815) – Fair Value Hedging – Portfolio Layer Method*.

We support the Board's efforts to respond to stakeholder questions associated with implementing the targeted improvements to the hedge accounting model for last-of-layer hedges introduced by ASU 2017-12. We believe the proposed ASU addresses those questions and would assist preparers in implementing the standard. We further believe that the proposed ASU aligns hedge accounting with entities' risk management practices and support the Board's decision to permit an entity to hedge multiple layers of a single closed portfolio. We also support the proposals that would provide guidance on accounting for and disclosing the fair value hedge basis adjustments.

However, we have identified the following additional guidance, clarifications and amendments that we believe are needed to ensure that the final ASU would be consistently applied and to minimize the likelihood that future interpretative guidance may be needed:

- separate the guidance on establishing subgroups from the guidance on qualifying requirements,
- reconsider the criterion that requires assets in the closed portfolio to become prepayable within a hedged period, and
- clarify the requirements for beneficial interests.

Appendix A provides our specific recommendations for the Board to consider. Appendix B provides our responses to the questions for respondents. Appendix C suggests language for a specific paragraph in the proposed ASU.

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If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at kbascom@kpmg.com or Mark Northan at mnorthan@kpmg.com.

Sincerely,

KPMG LLP

KPMG LLP

Appendix A – Summary of Recommendations

Separate the guidance on establishing subgroups from the guidance on qualifying requirements

We support the proposals to expand the guidance to allow an entity to design multiple-layer hedging relationships for a single closed portfolio of prepayable financial assets, including the creation of subgroups. The concept of subgroups is important for:

- determining whether the hedged item criteria in paragraph 815-20-25-12A are met,
- performing the similar-asset assessment, and
- allocating fair value hedge basis adjustments.

The proposals would establish subgroups of assets in a closed portfolio as part of the hedged item criteria (proposed paragraph 815-20-25-12A(d)(2)). We recommend the Board separate the guidance on establishing subgroups from the requirements for hedge accounting. We believe that the guidance on establishing subgroups should precede the requirements for hedge accounting (see Appendix C for suggested language). Isolating the discussion of establishing subgroups in this manner would:

- Facilitate reader understanding of the subgroup concept.
- Clarify how the hedge accounting requirements in paragraph 815-20-25-12A should be applied (i.e. by comparing the amount of the hedged layer with the amount of the assets *in the subgroup* that are anticipated to be outstanding).
- Streamline the requirements to qualify for hedge accounting by eliminating certain portions of criterion (d), which we believe are redundant with criterion (a). This is because criterion (d) is specifically designed to preclude a portfolio layer method hedge from qualifying for hedge accounting if the amount of assets with a contractual maturity date on or after the end of the hedged period is less than the aggregate amount of the hedged layers. We believe that hedge accounting in this circumstance would already be precluded by criterion (a).

Reconsider the criterion that requires assets in the closed portfolio to become prepayable within a hedged period

For a closed portfolio with multiple hedged layers, the proposed amendments indicate that one of the criteria to apply hedge accounting is that "all assets in the closed portfolio are or become prepayable by the end of the latest-ending hedge period of hedges associated with the closed portfolio."

It is not clear why the criterion is structured in this manner, and we believe it could potentially lead to unintended consequences. For example, this could lead an entity that wishes to hedge shorter-duration layers to establish a single hedged layer with a longer-duration solely to meet this criterion, even if that longer-duration layer is not consistent with the entity's risk management objective or the longer-duration layer is hedging only an insignificant amount.

If the Board's intent is that the assets supporting a portfolio layer method consist only of assets that are (or will become) prepayable during the hedged period, then we recommend the Board limit the subgroup for *each* hedged layer to only assets that have that characteristic.

Alternatively, if the Board believes that portfolio layer method hedge accounting should be permitted when some or all of the assets supporting the layer are not, and will not, become prepayable during the hedged period, we recommend removing the requirement to become prepayable before a certain date entirely. In this scenario, the Board would continue to require that the assets in the portfolio are or will become prepayable at some point, however they would not be required to become prepayable within a period covered by a portfolio layer method hedge.

Clarify the requirements for beneficial interests

The proposed amendments permit an entity to designate "a stated amount of…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…." The proposals also state, "If the closed portfolio includes one or more beneficial interests, the criteria in this paragraph shall not apply to the individual financial instruments securing the beneficial interest or interests."

We recommend that the Board (1) require that determining whether a beneficial interest is included in a subgroup of financial assets supporting a hedged layer be based on the estimated maturity of the beneficial interest at hedge inception and (2) clarify that the assets securing the beneficial interest must consist entirely of prepayable financial instruments (or, alternatively, consist entirely of prepayable financial assets and derivatives designed to mitigate interest rate risk).

Determining subgroups

The proposed paragraph 815-20-25-12A(d)(2) provides that, for a closed portfolio with multiple hedged layers, the subgroup of financial assets supporting each layer is determined by comparing the contractual maturity date of the financial instruments with the end of the hedge period. However, many beneficial interests do not have contractual maturity dates and the proposed amendments are not clear with respect to:

- whether these instruments would be eligible to be included in the closed portfolio, and
- if eligible, how an entity would determine in which subgroup of financial assets the beneficial interests supporting an individual layer would be included.

In addition, the contractual maturity date of some other beneficial interests may lack substance when cash flows are expected to cease well before the contractual maturity date.

We believe that requiring an entity to determine whether a beneficial interest is included in a subgroup of financial assets supporting a hedged layer based on the estimated maturity of the beneficial interest at hedge inception is the optimal solution from a cost-benefit perspective. Specifically, our recommendation would:

- permit entities to apply the guidance in the proposed amendments to beneficial interests without contractual maturity dates,
- leverage processes already needed to satisfy the criterion in proposed paragraph 815-20-25-12A(a) to estimate the maturity date of the beneficial interest based on the estimates of defaults, prepayments and other factors affecting the prepayable financial assets securing the beneficial interest, and
- continue to limit the subgroup determination to hedge inception, thereby ensuring that, when the criteria in proposed paragraph 815-20-55-14A are met, entities assess only at hedge inception whether the individual assets within the subgroup share a risk exposure.

Alternatively, if the Board believes that basing the subgroup determination on the estimated maturity date would be too burdensome for preparers, we suggest the Board consider clarifying through amendments to the Codification that only those beneficial interests with contractual maturity dates would be included in the closed portfolio.

Assets underlying the beneficial interests

It is not clear from the proposals whether *all* of the assets underlying the beneficial interest need to be prepayable. We recommend that the Board clarify through amendments to the Codification that the portfolio of financial instruments securing the beneficial interest must consist solely of prepayable instruments. This would be consistent with the requirements for other financial instruments in the closed portfolio, and would avoid the need for additional, complex guidance on the extent to which the portfolio would need to consist of prepayable financial assets (e.g. substantially all or a majority). Alternatively, if the Board believes this is too restrictive, it could consider permitting the beneficial interests to also be secured by interest rate derivatives if those derivatives are specifically designed to mitigate the impact of a mismatch between prepayable financial assets (which may be variable rate) and beneficial interests (which may be fixed rate).

Appendix B – Responses to Questions for Respondents

Question 1:

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

Yes, generally we believe the proposed amendments are operable and auditable, with the exception of the guidance on beneficial interests. Due to the unique nature of beneficial interests we believe further clarification (see Appendix A) is needed for entities to implement the proposed amendments.

Question 2:

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

We understand that entities have historically entered into derivatives to mitigate the interest rate risk of prepayable financial assets but typically were not able to achieve hedge accounting. We believe the multiple-layer hedge model would allow entities to align their risk management objectives with hedge accounting.

Question 3:

Do you agree with the Board's decision to limit the scope of the types of instruments eligible for 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.

Yes, we agree with the Board's decision as it would address the significant challenges that preparers identified in applying hedge accounting for prepayable financial assets.

Limiting the proposals in this manner would enable the Board to evaluate whether the new concepts incorporated into this guidance are operable in practice and how financial statement users are impacted. That would better position the Board to evaluate whether similar approaches should be permitted in the future for a broader range of financial instruments.

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 proposals on hedge dedesignation sequencing when a breach has occurred. Eliminating an entity's ability to select which hedge to dedesignate would eliminate the potential for manipulation of the income statement effect (amount or classification).

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.

Yes, we agree with the Board's proposed amendments on accounting for basis adjustments, including the proposed guidance on:

- allocating basis adjustments when a portfolio layer hedge is dedesignated and
- excluding the basis adjustment from the measurement of impairment under Topic 326 and from the recorded investment or amortized cost basis of financial assets under Topics 310 and 320, respectively.

However, we believe the Board should amend Topic 860 to clarify that the basis adjustment is excluded from the gain or loss calculation when an asset(s) in the closed portfolio is derecognized.

We believe that because the portfolio layer method allows entities to achieve hedge accounting for a closed portfolio of assets, it is appropriate to allocate the basis adjustment to the assets in the closed portfolio on dedesignation. Additionally, we agree with excluding the basis adjustment from the impairment assessments if an entity has separately determined that the hedged layer would not be impacted by defaults.

Further, we agree with the Board's proposals to include the basis adjustment in disclosures required by Topics other than Topic 815. We believe that the cost of disclosing the allocation of basis adjustments would likely outweigh the benefit.

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 believe financial statement preparers are best positioned to comment on the cost and effort needed to identify which assets in the closed portfolio caused the breach. However, we believe the expected costs could be overly burdensome in some circumstances. To identify which assets in the closed portfolio caused the breach, entities would need to have processes to determine the time sequencing of events (e.g. to determine whether the breach was due to prepayments, credit losses or a sale), which has historically not been part of the financial reporting process.

If the Board receives feedback from financial statement preparers that time sequencing is not cost beneficial, we recommend the Board consider allocating the basis adjustment on a pro-rata basis, based on activity within the reporting period.

This approach would permit entities to leverage existing information, as we would expect that entities already have processes in place to evaluate cumulative activity during the reporting period as part of the analyses required by proposed paragraph 815-20-25-12A(a).

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 a 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?

We are not aware that the proposals would require special considerations for the identified companies or entities.

Question 8:

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

We agree with the proposed transition requirements.

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 the public business entities? Please explain your response.

We believe financial statement preparers are best able to comment on the time needed to implement the proposed amendments. Additionally, we are not aware of factors specific to entities other than public business entities that would warrant a different implementation period.

Appendix C – Suggested Language to the Proposed Amendments

We have suggested language to the proposed amendments to illustrate aspects of the approach we recommend in *Separate the guidance on establishing subgroups from the guidance on qualifying requirements* in Appendix A. There may be other consequential amendments the Board would need to make throughout the proposals. The proposed language in 815-20-25-XX(b) is drafted using the first alternative raised in *Reconsider the criterion that requires assets in the closed portfolio to become prepayable within a hedged period* in Appendix A. Subparagraph (b) would be omitted if the Board's intent was more aligned to the second alternative.

> Eligibility of Hedged Items and Transactions
> > Hedged Item Criteria Applicable to Fair Value Hedges Only

815-20-25-XX Each hedged layer(s) permitted by paragraph 815-20-25-12A is supported by specific subgroups of assets within the closed portfolio, which will in some circumstances be less than all of the assets in the closed portfolio. Specifically, the subgroup of assets within a closed portfolio that support an individual layer would include only the assets in the closed portfolio that:

a. Have a contractual maturity date on or after the end of the hedged period for that individual layer, and
b. Are, or will become, prepayable before the end of the hedged period for that individual layer.

See paragraphs 815-20-55-14G through 55-14N for implementation guidance related to separating a single closed portfolio into subgroups.