ISDA | Safe, Efficient Markets

June 30th, 2025

Mr. Jackson Day
Technical Director
Financial Accounting Standards Board
801 Main Avenue
P.O. Box 5116
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By email: director@fasb.org

RE: File Reference No. 2025-ITC100, *Agenda Consultation*

Dear Mr. Day,

The International Swaps and Derivatives Association's (ISDA) [1] North American Accounting Committee (the "Committee") appreciates the opportunity to comment and provide feedback on the Financial Accounting Standards Board's ("FASB" or "Board") 2025 Agenda Consultation Invitation to Comment ("ITC"). Collectively, the Committee's members represent a broad range of derivatives market participants, including corporations, investment managers, insurance companies, and global and regional banks. The Committee brings extensive expertise in financial reporting and policy matters related to derivatives, hedge accounting, and broader risk management activities. The Committee's comments are informed by significant practical experience with the application of Accounting Standards Codification ("ASC") Topic 815, Derivatives and Hedging and related financial reporting topics impacting derivatives users.

The Committee appreciates the Board's proactive efforts to seek input on potential future standard-setting priorities and supports the continued refinement of accounting guidance to better reflect the economics of risk management. As noted throughout the responses, the Committee believes the highest priority should be given to continuing and expanding work on hedge accounting—including consideration of the FASB's Hedge Accounting project. The current hedge accounting framework has limitations that restrict the ability of hedging entities to align accounting outcomes with actual economic exposures. Addressing these challenges would meaningfully enhance the relevance and decision-usefulness of financial reporting for financial statement users.

In this letter, the Committee provides feedback on several questions in the ITC, focusing on areas that align with the Committee's core areas of expertise. The recommendations within are centered on refining hedge accounting under ASC 815, addressing gaps in the accounting for derivative modifications, and encouraging the Board to prioritize changes that would reduce operational complexity while improving the transparency and accuracy of financial statements.

1 Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 76 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on LinkedIn and YouTube.

Overall Questions for Respondents

Question 1 (All Respondents): Please describe what type of stakeholder you (or your organization) are from the list below, including a discussion of your background and what your point of view is when responding to this ITC:

a. Academic

b. Investor, other allocator of capital, or other financial statement user, such as:
   i. Equity analyst: buy side
   ii. Equity analyst: sell side
   iii. Credit-rating agency analyst
   iv. Fixed-income analyst
   v. Accounting analyst
   vi. Quantitative analyst
   vii. Portfolio manager
   viii. Private equity
   ix. Individual investor
   x. Lender
   xi. Long-only focus
   xii. Long/short focus
   xiii. Other

c. Practitioner/auditor

d. Not-for-profit organization preparer

e. Private company preparer

f. Public company preparer

g. Regulator

h. Standard setter

i. Other.

ISDA and the Committee fall under category (i) Other. ISDA represents a broad range of derivatives market participants, including corporations, investment managers, insurance companies, and international and regional banks. In responding to the ITC, the Committee is providing input from the perspective of financial institutions that actively use derivatives and hedge accounting to manage financial risk.

ISDA members use various risk management strategies to hedge their risks. However, the ability to use hedge accounting to reflect in financial reporting the best representation of how economic risks are being managed is limited. The Committee's responses to the ITC are informed by extensive engagement with preparers and users of financial statements that are affected by hedge accounting requirements across a variety of industries. As such, the Committee's recommendations focus on improving the alignment of financial reporting with the economics of risk management activities, reducing unnecessary complexity, and enhancing the operability of hedge accounting for common financial instruments.

Question 2: Which topics in this ITC, including those related to current technical and research agenda projects, should be a top priority for the Board? Please explain, including the following:

a. Why there is a pervasive need to change GAAP (for example, what is the reason for the change)

b. How the Board should address this topic (that is, the scope, objective, potential solutions, and the expected benefits and expected costs of those solutions)

Why is this topic a top priority and what is the urgency to complete standard setting on this topic (that is, how quickly the issues need to be addressed).

Executive Summary:

The Committee believes that expanding the hedge accounting model through a dedicated broad scope project or projects should be among the Board's highest priorities. The objective of hedging is for an entity to minimize the potential impacts of economic risks. Consistent with this, the objective of hedge accounting should be to provide financial statement users with the most faithful representation of the results of an entity's risk management activities (i.e., through reduced exposure to market price fluctuations or volatility in earnings).

However, there are a number of limitations in generally accepted accounting principles ("GAAP" or "U.S. GAAP") that limit or preclude financial statement preparers from applying hedge accounting where economic hedging activities are routinely applied. These limitations often result in mismatches between reported results and true net economic exposures, which results in earnings volatility, operational burdens, and potentially disincentivizes entities from applying hedge accounting at all—not because they lack the desire to align the financial reporting impact of their economic hedges to the risk management activities, but because the accounting requirements are overly narrow, complex, or burdensome.

The Committee explores approaches to how the cash flow hedging model can be improved to broaden its application without introducing potential abuses. The key concepts explored include focusing the cash flow hedge accounting model on accruals as opposed to the actual cash flows considering that U.S. GAAP is an accrual method of accounting, and more in-line with the exposure and economic results entities are hedging. As it relates to this proposed model, the Committee further contemplates how this model could address challenges in determining the specificity of forecasted transactions and assessing the probability of the forecasted transactions occurring. The Committee also explored improvements to the fair value hedge accounting model. In particular, the current fair value hedge accounting model is limited to closed portfolios of assets for portfolio hedges. The Committee is seeking the FASB to consider expanding the portfolio layer method to allow for the designation of open pools and to liabilities. The Committee also considered targeted improvements to the hedge accounting model to remove certain restrictions, such as only allowing entities to hedge a benchmark interest rate and prohibiting the hedging of held-to-maturity securities. There are various other areas of Topic 815 that the Committee has addressed in the response for the Board to consider.

Addressing this overarching concern to better align hedge accounting outcomes with real-world risk management activities would significantly improve financial reporting. The Committee's recommendations include both broad improvements to the hedge accounting model and specific changes to individual paragraphs in the Accounting Standards Codification ("ASC") that currently limit how hedge accounting can be applied. Some recommendations focus on aligning the guidance more closely with how entities manage risk in practice, while others address narrow issues—such as eligibility requirements or effectiveness testing—that create unnecessary barriers to applying hedge accounting. This letter reflects both types of changes and is organized to highlight where updates to the overall framework are needed, as well as where targeted revisions to existing paragraphs would help. To emphasize, the Committee's intent with these recommendations is not a complete overhaul of the existing hedge accounting framework or introduction of a new model, rather, the Committee supports a broad scope project to enhance the current model.

Committee Response to Question 2:

The Committee recommends that the Board prioritize a project or projects to address the following areas (presented in priority order). The Committee has provided details below about the matters to be addressed within each area:
The Committee recommends that the Board prioritize a project or projects to address the following areas (presented in priority order). The Committee has provided details below about the matters to be addressed within each area:

- Accrual-based cash flow hedging model;
    - Hedging accruals versus cash flows
    - Specificity of the forecasted transactions
    - Forecasted transaction probability related to de-designated cash flow hedges
- Expansion of fair value hedging:
    - Portfolio layer hedging
        - Portfolio layer method hedges for open pools
        - Portfolio layer method hedges for pools of liabilities
    - Interest rate risk
        - Fair value hedging of contractually specified rates (expand U.S. Dollar hedges of interest rate risk beyond a specific list of benchmark interest rates)
        - Hedging interest rate risk in held-to-maturity ("HTM") securities
        - Prepayment risk
- Hedging of economic risks that do not directly affect earnings;
- Other potential modifications to existing guidance.
    - Designating float-for-float cross-currency swaps in a net investment hedge when the reset periods do not match
    - Designate certain compound derivatives as net investment hedges
    - Hedge of fair value changes of loan commitments
    - Translation risk associated with foreign-currency denominated subsidiaries
    - Ability to use spot method for imperfect net investment hedges (scope)
    - Repricing and Payment date differences when using the 'long-haul' method
    - Shortcut method criteria
    - Ability to designate non-derivative instruments as hedges

Accrual-based cash flow hedging model

The Committee believes that improvements to the cash flow hedging model should be among the highest priorities for the Board. There is a significant opportunity to simplify the model to focus on how earnings are recognized – on an accrual basis – and focusing on transaction volumes for certain hedging relationships rather than the exact timing of forecasted cash flows. As discussed in this section, this would better align hedge accounting with current risk management in practice.

Hedging accruals versus cash flows

Under GAAP, accounting generally reflects items on an accrual basis rather than a cash basis. The cash flow hedge accounting framework would be improved if it more closely aligned with accrual reporting and de-emphasized the importance of the timing of movements of cash. Such movements commonly settle payables and receivables and rarely affect the income statement).

In other words, the release of cumulative market value adjustments on hedging derivatives recorded to other comprehensive income ("OCI") is not timed to offset actual collections of cash, rather it is aligned to offset the income statement variability generated by changes in the variable rates used to accrue interest income or expense related to the hedged items.

As a result, the cash flow hedge accounting model needs to focus on accruals when evaluating whether a hedge is highly effective. Entities generally do not accrue interest income when collection is not probable. Entities are required to record interest expense when the obligation is incurred. The Committee believes that as long as there is a sufficient amount of probable cash flows that will follow those accruals, and the hedge relationship is highly effective, hedge accounting should be permitted.

Specificity of the forecasted transactions

If the cash flow hedging model focused on accruals that affect earnings rather than cash flows that do not impact earnings, it would be less important to identify and sequence individual forecasted transactions. Under an accrual-based model, there would be no need to specify specific cash flows. Instead, entities could demonstrate a sufficient volume of forecasted transactions is probable of occurring—not whether each individual transaction is precisely identified and tied to a particular date. This approach would be more consistent with how entities manage interest rate exposures. It also becomes less important to identify and sequence derivatives based on the chronological order in which they require cash flows. Two hedging derivatives may have similar terms related to notional amount, underlying index, and reset dates, but could vary with respect to payment dates (e.g., one may settle quarterly and the other may settle semi-annually). These derivatives will generate similar changes in market value each day, and both will be recorded to OCI assuming they are highly effective hedges. This OCI will be released to offset the impact of the forecasted hedged items as they affect earnings, which will also be based on accruals and not cash movements. The difference in payment frequency of the derivatives should have no impact on cash flow hedge accounting (other than slight differences in time value that would be contemplated in the hedge effectiveness assessment of the derivative).

It then follows that the cash flow hedge accounting model should become more of a volume-based test, which focuses on whether it is probable that there will be sufficient forecasted transactions relative to the hedging derivative. The model should not focus on identifying and analyzing individual derivatives or specific forecasted transactions for the purpose of comparing the sequence and timing of cash payments. This would greatly simplify the hedge accounting model without sacrificing the requirement that hedges must be highly effective.

This notion is consistent with the provisions of the recent Proposed Accounting Standards Update – Hedge Accounting Improvements, which will potentially modify the requirement that individual interest payments being hedged as a group must vary with the same index and instead allow such payments to be hedged as a group if they share **a similar risk exposure.**

This change will allow entities to perform hedge effectiveness testing based on a comparison of the rates included in the pools to ensure all rates are highly effective versus the hedging derivative and thus represent similar risk exposures. Taken further, once proven that all of the rates are similar, the composition of the group by type of rate is no longer relevant.

As a result, this further supports a simplification of the cash flow hedge accounting model to require a volume-based test to ensure a sufficient volume of forecasted transactions are probable of occurring, as opposed to a requirement to sequence and catalog individual forecasted transactions by index, payment frequency, next payment date or other factors that are not relevant in an accrual-based accounting model.

Such a framework would require entities to demonstrate that the volume of qualifying hedged forecasted transactions remains probable of occurring and that the hedging instrument is highly effective for that specified volume of the hedged item. This would more closely align the hedge accounting guidance with the approach taken by risk management to identify aggregate risk exposures and enter into derivatives to mitigate that risk. Aligning the framework to focus on the volume of the hedged item with the defined risk exposure, as long as the hedging instrument is highly effective against the hedged risk, would significantly reduce unnecessary operational complexity and more closely align the hedge accounting framework with the risk management practices of the entity.

Additionally, when hedging forecasted issuances of debt, the guidance explicitly states the entity must designate changes in the hedged risk as either changes in the coupon payments on the debt or the total proceeds for new debt.

ASC 815-20-25-18: *Provided the entity meets all the other cash flow hedging criteria, an entity may designate as the hedged risk the risk of changes in either of the following:*

a. The coupon payments (or the interest element of the final cash flow if interest is paid only at maturity) related to the forecasted issuance of fixed-rate debt
b. The total proceeds attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed-rate debt.

The derivative instrument used to hedge either of these risks must provide offsetting cash flows for the hedging relationship to be effective in accordance with paragraph 815-20-35-3.

This is another example where the specificity requirement in defining the hedged risk is overly restrictive on entities, thus limiting or preventing their ability to apply hedge accounting. Similar to above, the Committee believes how the hedged risk is defined can be broadened to encompass a degree of uncertainty. For this strategy specifically, the requirements in ASC 815-20-25-18 (a) and (b) should be revised to allow for the forecasted hedged risk to be either coupon payments **or** total proceeds, **or both** within a single hedging relationship. When companies hedge forecasted debt issuances or purchases, they are not hedging the specific cash flow. Rather, they are hedging the yield the bond will generate regardless of whether this comes to fruition in the form of trade proceeds or the coupon payments. Entities often do not know at hedge inception whether they will hold a bond and receive the interest payments or sell the bond and realize proceeds—yet the economic risk being hedged is the same.

Forecasted transaction probability related to de-designated cash flow hedges

Pursuant to ASC 815-30-40-4 and 40-5, there is a requirement that after the de-designation of a cash flow hedge, the forecasted transactions must still remain probable of occurring as forecast (or within the additional two-month period of time), or else the entity will be deemed to have a missed forecast, whereby some or all amounts previously deferred in OCI must be reclassified into earnings immediately related to the forecasted transactions that are no longer probable of occurring.

ASC 815-30-40-4 *The net derivative instrument gain or loss related to a discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter, except as indicated in the following sentence. In rare cases, the existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the reporting entity may cause the forecasted transaction to be probable of occurring on a date that is beyond the additional two-month period of time, in which case the net derivative instrument gain or loss related to the discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income until it is reclassified into earnings pursuant to paragraphs 815-30-35-38 through 35-41.*

ASC 815-30-40-5 *If it is probable that the hedged forecasted transaction will not occur either by the end of the originally specified time period or within the additional two-month period of time and the hedged forecasted transaction also does not qualify for the exception described in the preceding paragraph, that derivative instrument gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately. A pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.*

Under U.S. GAAP, multiple occurrences of missed forecasts can result in an entity being prohibited from applying cash flow hedge accounting. The immediate release of cumulative amounts from OCI to earnings and prohibiting an entity from applying cash flow hedge accounting are significant penalties. This creates a situation where preparers end up applying a near-certain" threshold in practice, which is a conservative approach even though the standard sets a "probable" threshold for forecasted transactions.

A missed forecast is deemed to have occurred, although the forecasted transaction may still be probable of occurring within 60 days after the initially documented forecast timing. This restriction, as well as the significant penalties that may be incurred prevents entities from executing hedge accounting for specific transactions where the exact timing may be unknown or for a large portion of their interest rate exposure in portfolio hedges due to prepayment risk in the pool (i.e., a significant "buffer" amount remains unhedged to avoid a missed forecast). As a result, earnings volatility is introduced, because entities may instead economically hedge portions of their risk exposures that would otherwise qualify for hedge accounting. The Committee recommends making the probability of the transaction occurring be the defining term but not require a specific date or time range.

In line with the recommendation above, the Committee recommends removing the 60-day limitation in both ASC 815-30-40-4 and 815-30-40-5 and allow that a transaction that remains probable of occurring to avoid being deemed a failed forecast solely because the timing estimate is not within an arbitrarily-set window of time.

If the Board believes a specific time frame deadline is required, the Committee suggests extending the two-month period after the originally specified time-period to one year.

In summary, the current cash flow hedge accounting model presents significant challenges for entities, particularly banks, where originating loans and taking deposits are fundamental business activities. These financial products create complex interest rate dynamics. For example, the amount of receiver swaps designated in a bank's portfolio cash flow program depends on factors such as the origination breakdown between variable and fixed-rate loans, their expected economic life, and the stickiness of the deposit base in response to interest rate changes. The risk management objectives of hedges often extend beyond merely hedging specific types of cash flows. Therefore, it is crucial that such core risk management activities qualify for hedge accounting to ensure that financial reporting accurately reflects the results of risk management.

The current cash flow hedge model can be particularly detrimental to banks, as it often fails to accommodate the nuanced and dynamic nature of their risk management strategies. Banks must navigate complex interest rate environments and manage diverse portfolios of financial products, yet the existing framework may not fully capture the economic realities of these activities in a balanced fashion. This misalignment often hinders banks' ability to effectively communicate successful risk management activities in their financial reporting.

To better align risk management activities with accounting results, the accounting model should focus on the underlying variable interest exposures that risk management activities aim to address. This includes the intention to swap variable interest income to better align with fixed interest expenses (explicitly or implied) on the liability side. In addition to the concepts discussed earlier, the Board should consider other targeted changes to the model, such as allowing entities to define their hedge strategy as a hedge of generic variable interest rate exposure and acknowledging that eliminating variability using a cash flow hedge relates to income or expense accruals, rather than specific cash flows. Specifically, allowing the designation of forecasted accruals as hedged items instead of specific cash flows would more closely align the hedge accounting model with the risk management activities associated with managing interest rate risk. Additionally, providing the flexibility to change hedged risk prospectively would enable the replacement of hedged accruals with the next available accruals, thereby enhancing the alignment between risk management practices and accounting outcomes.

By implementing these changes, whether as exceptions to the cash flow hedge accounting principles or not, the accounting model could better support banks in their core risk management activities, ensuring that financial reporting more accurately reflects the economic substance of their strategies. This alignment would not only reduce unnecessary operational complexity but also enhance the transparency and usefulness of financial statements, ultimately benefiting both banks and their stakeholders.

Expansion of fair value hedging:

The Committee believes there are opportunities for the expansion of fair value hedge accounting with respect to the newly introduced portfolio layer method, as well as other hedges of interest rate risk.

Portfolio layer method

Portfolio layer method hedges for open pools

The conceptual basis and opportunities for abuse are not clear with respect to why a portfolio layer method ("PLM") hedge may only be designated against a closed pool of assets. Specifically, when the concept of a fair value portfolio hedge of prepayable assets was introduced by ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, the original concept was known as a "last of layer" hedge. A closed pool is consistent with such a hedging strategy, as there would be no other way to know whether the "last" layer would remain sufficient to provide a highly effective hedge, without having a closed pool.

When the last of layer method was modified to become PLM under ASU 2022-01, *Derivatives and Hedging (Topic 815): Fair Value Hedging – Portfolio Layer Method*, there appears to be less of a conceptual need for the hedged item to be a closed pool of assets. Specifically, the Committee believes a highly effective hedge could be designated against an open pool of fixed rate assets as the hedged item. Under such a hedge, the hedging derivative would dictate the tenor of the hedge relationship (unless a shorter tenor was designated), and the hedge would reasonably be expected to be highly effective, as long as there was a sufficient volume of qualifying fixed-rate assets added to the pool such that the total outstanding always equaled or exceeded the notional of the hedging derivative. Such an approach would be more consistent with the macro interest rate risk management activities.

To address the mechanical considerations that come up in an open pool structure—particularly at de-designation—the Committee recommends that the Board allow a policy election to allocate the basis adjustment either (1) over the life of the individual assets supporting the pool or (2) over the hedge period. At the time of de-designation, the remaining basis adjustment would be allocated to the then-existing assets in the pool on a rational and systematic basis. This additional flexibility would provide operational clarity while maintaining hedge accounting.

Portfolio layer method hedges for pools of liabilities

Financial liabilities continue to be excluded from the scope of the PLM. In comment letters responding to Proposed ASU 2022-01, the Committee and other stakeholders encouraged the FASB to include financial liabilities in the scope. Many of the same challenges exist for fair value hedges of a portfolio of prepayable financial liabilities, such as certificates of deposit that are permitted to be put back to the issuing financial institution upon the holder's death.

The Committee recommends the Board reconsider the ability to apply the portfolio layer method to financial liabilities. This could be applied to open pools, if such an approach is adopted for prepayable assets, or to closed pools consistent with current GAAP. In practice, this means allowing an entity to designate a layer within a portfolio of prepayable liabilities in a fair value hedge of interest rate risk, similar to what is permitted for assets. The Committee believes the same objectives and mechanics from the asset-side portfolio layer approach can be applied, as the hedge accounting technique (recognizing basis adjustments for the hedged layer) is fundamentally the same.

Additionally, demand deposits, such as checking or savings accounts, are callable at will and do not have stated maturities. However, institutions routinely model these liabilities as long-duration exposures based on customer behavior and regulatory guidance, recognizing their economic lives often extend several years. These non-maturity core deposits represent a significant source of interest rate risk for banks, and their stability over time is well-understood and actively managed through risk modeling. Despite this, current hedge accounting guidance under ASC 815 explicitly limits the portfolio layer method to financial assets and does not permit portfolios of financial liabilities—such as demand deposits—to qualify. These core deposits are a major source of interest rate risk and are managed as such, but current ASC 815 guidance limits the PLM to financial assets, which prevents these economically meaningful liabilities from being designated in hedge relationships.

The Committee believes that portfolio layer hedging should be permitted for demand deposits when institutions can demonstrate, through modeling and back-testing, that these liabilities exhibit stable, predictable behavior over time. While current guidance requires hedged items to have a contractual maturity date, institutions manage demand deposits based on their expected duration, which is typically estimated using behavioral models and regulatory assumptions that reflect how long customers are likely to keep funds on deposit. The Committee recommends the Board consider amending the PLM framework to permit the use of an assumed maturity date later than the contractual maturity, consistent with how the Board has already allowed the use of partial-term hedging based on expected rather than legal maturities for fixed-rate assets. Companies typically manage demand deposits as if they are long term fixed rate liabilities for risk management purposes. For the reasons listed above, it is difficult to achieve hedge accounting when derivatives are used to manage the interest rate risk associated with deposits that are effectively managed as long-term liabilities.

Under International Accounting Standards ("IAS") 39, a specific rule was made to allow for hedging 'core deposits'. Core deposits are customer deposits (including either on demand or term deposits) that remain on deposit for a relatively long period. The stability arises as withdrawals are mostly offset by additional deposits. Because it is common for customers to maintain demand deposit accounts for an extended period of time, risk managers often identify a part of the demand deposit portfolio that is considered to be stable and treat these 'core demand deposits' as a fixed interest rate liability for risk management purposes. The concept of 'core deposits' is also included in the new dynamic risk management hedge accounting proposal. Allowing demand deposits to be hedged under a portfolio layer method, similar to International Financial Reporting Standards ("IFRS"), would more closely align the hedge accounting framework with risk management activities.

This would also address issues faced by insurance companies. Insurance companies have highly predictable liabilities at the portfolio level. At the portfolio level, various assumptions can be made around the behavior and trends of the policy holders and expected future settlements can be reasonably predicted. However, without the portfolio layer method, companies have to be able to demonstrate each policy is similar. The ability to determine each insurance policy in a portfolio can be impractical or even impossible due to outliers in the portfolio or wide range of assumptions that need to be considered for each individual policy holder.

The expected benefits are significant: entities could more easily hedge interest rate exposure of core deposits or similar liabilities, improving alignment with risk management. Given the success of the portfolio layer method for assets, expanding it to liabilities is an area that the Board should pursue.

Interest rate risk

Fair value hedging of contractually specified rates (expand U.S. dollar hedges of interest rate risk beyond a specific list of benchmark interest rates)

The Committee believes that the ability to hedge contractually specified rates should not be limited solely to cash flow hedges but should be extended to fair value hedges as well. The Committee note that there have been no substantive issues, financial statement restatements, or abuses that have arisen in relation to cash flow hedges of contractually specified rates. For fair value hedges, where the hedged items are all fixed rate in nature, the contractually specified rate would be dictated by interest rate underlying the hedging derivative.

Under ASC 815-20-25, fair value hedges of financial assets and liabilities denominated in US dollars may only reference a specific list of benchmark interest rates. Similar hedges of financial assets and liabilities denominated in other currencies are not limited to a specific list of benchmark interest rates.

There is no conceptual basis to preclude fair value hedges from designating these hedges (i.e., due to a lack of shared risk exposure with the derivative). An entity may currently designate a benchmark interest rate hedge without demonstrating any element of shared risk between the hedge and the hedged item (e.g., a pay-fixed, receive-SIFMA Municipal Swap Rate swap may be designated in a fair value hedge of a fixed-rate commercial loan with no inherent exposure to SIFMA). To the extent the notional and payment frequency of the hedging derivative match the hedged item, the hedge is expected to be highly effective regardless of the rate underlying the derivative. In addition, there is little opportunity for abuse, as market participants must execute hedging derivatives with third parties that would have no interest in executing derivatives not subject to market-based pricing and valuation.

For the avoidance of doubt, the Committee believes a list of specific U.S. benchmark interest rates could be retained as a requirement to apply the shortcut method, but such a list would not be limiting for entities willing to demonstrate that a proposed hedging strategy is expected to be highly effective on a long-haul basis. In that case, any contractually specified rate—including Term SOFR—should be eligible as the designated risk in a fair value hedge. The Committee encourages the Board to consider adding Term SOFR to the list of benchmark rates as a near-term practical step, and to separately consider whether the benchmark rate concept remains necessary at all, given that highly liquid and widely used rates could be eligible based on effectiveness alone.

Hedging interest rate risk in HTM securities

The Committee published a whitepaper[2] on a number of hedge accounting related issues experienced by financial and non-financial institutions. The whitepaper provided background on interest rate risk exposures, how they are commonly risk managed and the challenges to achieving hedge accounting. The ability to hedge HTM securities was also explored in that paper.

In summary, securities classified as HTM may not be hedged for interest rate risk pursuant to ASC 815-20-25-43, on the basis that an entity should be indifferent with respect to how interest rate risk may affect the value of the securities because it is committed to holding the securities until maturity, thus receiving the full amount of its anticipated return, regardless of interest rates.

> *815-20-25-43 Besides those hedged items and transactions that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedged item or transaction in the respective hedges:*
>
> *b. With respect to fair value hedges only:*
>
> > *2. For a held-to-maturity debt security, the risk of changes in its fair value attributable to interest rate risk*
>
> *d. With respect to cash flow hedges only:*
>
> > *2. If variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Topic 320, the risk of changes in its cash flows attributable to interest rate risk*

In Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("FAS 133"), the FASB explained in its basis for conclusions that the ability to hedge a HTM position would contradict the logic of its classification. This is because when an entity makes this classification, it is inherently asserting that it intends to hold the security until maturity and recover the principal, disregarding any effects of changes in interest rates.

While it is true that entities are committed to holding HTM securities, it is not correct to assume that entities are indifferent with respect to the interest rate risk associated with those securities, as entities take actions or execute other transactions to economically compensate for the impacts of this "unmanageable" interest rate risk. Specifically, for asset liability management ("ALM") reasons, managing the risk of the entire balance sheet, including economically hedging HTM securities, has always been required. Despite a bank holding HTM securities to maturity, the long duration exposure of those securities may need to be reduced due to other changes within the balance sheet. For example, as deposits contract (in duration terms, get shorter), the net duration of the balance sheet will become too long, resulting in the need to reduce fixed-rate assets or swap them to floating rates in order to return to the previous net duration position.

Since HTM securities can neither be sold nor hedged for interest rate risk, financial institutions are limited in the available risk management actions that may be taken. Other available assets or liabilities are sometimes designated in accounting hedges that serve as proxies for hedges of the HTM securities, but often these hedges are not sufficient to address the interest rate risk related to HTM securities, as the hedged items are often subject to hedges that mitigate the item's own interest rate risk.

The prohibition of interest rate risk hedge accounting for HTM securities is inconsistent with how entities approach their interest rate risk management, which is executed on a balance sheet-wide basis, and not by risk managing individual or subsets of assets. In the absence of a macro hedging strategy, allowing entities to hedge the interest rate risk of HTM securities as part of ALM would significantly improve entities' abilities to align the hedge accounting guidance with risk management activities. In other words, entities execute derivatives that may be effective economic

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[2] Hedge-Accounting-Under-US-GAAP.pdf

hedges of the HTM interest rate risk, but because the accounting for such risk management is not aligned, it creates financial statement results that may be misleading and not representative of the economic reality of being managed. For example, an entity executing economic hedges of HTM interest rate risk will be required to carry the derivatives at fair value with changes in value reflected in earnings, while the HTM securities are not adjusted for changes in the hedged risk, which creates undesirable income statement volatility although the true economic risk has been mitigated.

The Committee notes that held-for-investment ("HFI") loans are also held at amortized cost and the entity's management makes a positive assertion at origination or purchase regarding its ability and intention to hold or sell loan receivables. However, unlike HTM securities, hedge accounting for interest rate risk is permitted for HFI loans.

While the classification criteria for HFI loans is a less restrictive hurdle in comparison to the criteria for HTM securities, and the reclassification between HFI and HFS is simpler, a vast majority of HFI loans are held to their legal and final terms by institutions. Hedge accounting has been deemed appropriate for loans that are in many cases held to maturity and impact earnings in similar ways to HTM securities.

If the application of hedge accounting to HFI loans is deemed to be separate from the entity's intention to hold the loan for the foreseeable future, the Committee believes this can be true for HTM securities as well – for example, when such hedges are conducted as part of an entity's ALM activities. An entity's decision to classify a security as HTM means that, during the term of the security, the entity's intentions with respect to that security will not be affected by interest rate changes, but hedging the interest rate risk of the security can be viewed separately from the ability and intention to hold the security to maturity, similar to the approach for HFI loans. Expanding the ability to hedge HTM securities appears to align with the existing ability to hedge HFI loans and should be permitted in the short term.

Prepayment risk

ASC 815-20-25-6 indicates that "*An entity shall not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the overall fair value of that prepayment option, perhaps thereby achieving the objective of its desire to hedge prepayment risk*."

Issuers of callable debt-instruments are likely paying coupon rates that are higher than coupons associated with similar non-callable instruments. The issuer may seek to hedge this risk by writing an option on an interest rate swap. As interest rates decrease, the embedded call option and the written option will both change in fair value and offset. However, the requirement to hedge the changes in the overall fair value of a prepayment option in a financial instrument prevents entities from being able to hedge the interest rate risk associated with that prepayment option. The overall fair value of the embedded call option will include changes in fair value due to the issuers credit risk while changes in fair value of the written option is primarily only driven by changes in rates.

The Committee believes the Board should remove the requirement that the option component of a prepayable instrument can only be hedged for overall changes in fair value. This will align the accounting with the economic effects of the hedging performed when prepayment options are hedged with swaptions and cancellable interest rate swaps, which are economically similar instruments.

<u>Hedging of economic risks that do not directly affect earnings</u>

ASC 815 requires hedged items to present an exposure to change in fair value attributable to the hedged risk that could affect reported earnings. Specifically, the inability to hedge such transactions is stated in ASC 815-20-25-12(c):

> *The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings. The reference to affecting reported earnings does not apply to an entity that does not report earnings as a separate caption in a statement of financial performance, such as a not-for-profit entity (NFP), in accordance with paragraph 815-20-15-1.*

Risks eligible for hedging under ASC 815 (for financial instrument-related exposures) are market price risk, interest rate risk, foreign exchange risk and credit risk. However, there are other economic exposures that entities actively manage and hedge, but they do not directly affect earnings, such as forecasted non-functional currency transactions, long-duration contracts and inflation risk. Permitting hedge accounting for these hedging relationships would better align financial reporting with risk management activities.

To address the specific items presented below, the Committee suggests the Board broadly reconsider the requirement related to "affect reported earnings" and believes the requirement for an item to affect reported earnings does not need to be removed from U.S. GAAP but should be expanded in order to align the definition to that used by risk managers.

Specifically, the interpretation of "affect reported earnings" in the ASC paragraph cited above is too narrow to allow entities the ability to hedge these economic risks that have a true financial impact. The "affect reported earnings" concept should be expanded to include hedges that are commonly transacted for risk management purposes and not only have a direct effect on reported earnings (e.g., variability in forecasted interest payments) but also an indirect effect on earnings. An indirect impact on earnings arises from changes in exchange rates, which increases or decreases the functional currency equivalent amount required to settle the forecasted transaction. This in turn indirectly affects earnings, because the functional currency equivalent basis of the item reflects the unhedged changes in exchange rates that occurred over the forecasted period, which results in asset amortization, interest income or expense recognition, or other income statement impacts that could have been avoided if the entity had been allowed to hedge the exposure during the forecasted period.

For example, the concept could be broadened to include all elements of an entity's reporting related to earnings (i.e., including comprehensive income and retained earnings). Given that entities clearly view certain economic exposures to be sufficiently significant so as to execute hedging transactions that can cause earnings volatility on an accounting basis (while the actual economic risk has been mitigated), these activities should be afforded special hedge accounting to more closely align hedge accounting with an entity's risk management activities.

Below are targeted examples of how this concept can be broadened as compared to current GAAP.

Foreign exchange risk associated with forecasted non-functional currency transactions

Entities face an actual economic risk that forecasted foreign-currency transactions will generate an uncertain amount of functional currency. Because this represents a true economic risk, entities commonly take measures to mitigate the risk using derivatives that do not qualify for hedge accounting. Examples of forecasted foreign currency transactions that have an economic impact, but do not affect reported earnings, include the following:

- Forecasted foreign currency-denominated transactions, such as the forecasted purchase of available-for-sale securities or the issuance of non-functional currency debt.
- Forecasted foreign currency-denominated business combinations.

As an example, in the case of a forecasted foreign-currency-denominated debt issuance, changes in exchange rates affect the functional currency equivalent amount of proceeds expected to be received, which in turn impacts the future interest expense reported in earnings. If a company receives less functional currency equivalent proceeds than initially forecasted due to a change in foreign exchange rates, the total functional currency-denominated interest expense over the life of the debt would be proportionally lower.

Said differently, while the impact at issuance may not hit earnings immediately, it changes the financial results over time. Preparers consider an exposure to earnings to include differences between the functional currency equivalent value of forecasted transactions on the forecast or budget date versus the actual transaction date. Financial statement users expect issuers to mitigate risks associated with foreign currency transactions. A forecasted foreign-currency-denominated debt issuance may be hedged by entering into a foreign-currency swap to swap the foreign currency from the debt issuance for the functional currency of the company. Because hedge accounting cannot be applied, the company is exposed to earnings volatility from the derivative. The ability to apply hedge accounting would allow the change in fair value of the derivative to be classified in OCI until the forecasted issuance occurs, to be released as an adjustment to the yield on the debt.

Long-duration contracts

In addition to forecasted foreign currency transactions, the Committee notes that changes to this requirement would also allow hedge accounting for Long-Duration Contracts after the long duration targeted improvements project (e.g., when they impact OCI but not earnings). Insurance companies with Long-Duration Contracts may reflect the economic impact of those liabilities in OCI as opposed to in earnings. However, these transactions also have an impact on the economic performance of the company.

Inflation risk

Inflation risk is not viewed as a contractually specified interest rate that may be designated in a cash flow hedge relationship. However, from an economic perspective, the holder of a bond faces a true reinvestment risk due to inflation during the life of the bond. For example, when a bond matures, the holder may receive $100, but the economic value of that $100 is less than it was at the time of purchasing the bond (if inflation was rising). If the bond was hedged for inflation risk, the value of the bond plus the derivative at maturity would be $110 – $100 for the bond principal and $10 for the increase in the fair value of the derivative – allowing the holder to maintain the economic value of the bond. The Committee recommends adding inflation risk as an eligible risk that may be hedged.

In summary, the Committee believes that if the definition of "affect on reported earnings" were expanded, it would not introduce opportunities for abuse in the economic risk hedges listed above. Specifically, entities would be required to demonstrate the economic impact of the hedged item. Additionally, an entity would need to demonstrate that the hedge relationship is highly effective, there is a sufficient volume of the hedged items, and for forecasted transactions, that they are probable of occurring. Said differently, entities would have no economic incentive to execute derivative trades as economic hedges if they actually increase net economic risk because there is no underlying economic risk to be managed.

Alternatively, there are tactical and targeted solutions the Committee suggests the Board take to address these issues. For example, the Board could amend ASC 815-20-25-12(c) and similar guidance that requires the hedged item to present an exposure to earnings attributable to the hedged risk. The definition could be expanded to include differences between a functional currency equivalent value of forecasted transaction on forecast or budget date versus actual transaction date. This concept was explored by the FASB in Derivative Implementation Group ("DIG") implementation issue No. H17, which was never finalized.

<u>Other potential modifications to existing guidance</u>

The Committee believes there are a variety of other potential modifications to existing GAAP that would greatly improve the current hedge accounting model.

Designating float-for-float cross-currency swaps in a net investment hedge when the reset periods do not match

According to ASC 815-20-25-67, hedging instruments that are eligible for designation in a net investment hedge include a receive-variable-rate, pay-variable-rate cross-currency interest rate swap, provided the interest rates are based on the same currencies contained in the swap and both legs of the swap have the same repricing intervals and dates.

This is because a cross-currency interest rate swap with either two floating legs or two fixed legs has a fair value that is primarily driven by changes in FX rates rather than changes in interest rates. Therefore, FX risk rather than interest rate risk is the dominant risk exposure in such a swap.

Following reference rate reform, how reset dates are applied began to vary significantly across different rates and jurisdictions. As a result, it is difficult to achieve hedge accounting using a float-to-float swap in a net investment hedge. However, entities should still be permitted to use a float-to-float swap in a net investment hedge even when repricing dates do not align, as long as the interest rate tenor is the same across currencies. The Committee suggests removing the requirement to also have the same repricing dates, to allow some flexibility in entering into the derivative contract. For example, the FASB can permit a difference in reset dates of up to a reasonable interval (e.g., 3 or 6 months) as long as the hedge is highly effective and has the same repricing intervals, the repricing date should not be considered a critical term.

Designate foreign currency hedges of variable rate forecasted transactions without the requirement to also hedge interest rate risk.

A cash flow hedge of a recognized foreign-currency-denominated asset or liability is only permitted when all of the variability in the hedged item's functional currency equivalent cash flows is eliminated by the effect of the hedge. That is, an entity cannot exclude a risk from the hedge that will affect the variability in cash flows of the hedged item.

> *815-20-25-39A hedging relationship of the type described in the preceding paragraph qualifies for hedge accounting if all the following criteria are met:*
>
> *d. If the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item's functional-currency-equivalent cash flows shall be eliminated by the effect of the hedge.*

This requirement has the unintended consequence of prohibiting cash flow hedging of foreign currency risk that arises from forecasted transactions when interest payments are variable. For example, a transaction in which a variable-rate, foreign-currency-denominated debt instrument is swapped into a variable-rate functional currency loan through one or more derivatives would not qualify as a cash flow hedge, since all of the variability in the functional currency cash flow is not eliminated (variability remains as a result of the functional currency variable interest payments).

The Committee recommends that the Board consider permitting a more flexible approach—similar to volume-based macro cash flow hedging principles already supported above within this letter in the section titled 'Exploring the Ability to Hedge Accruals/Aggregated Exposure: Beyond Specific Cash Flows'. Therein, the Committee describes a revised framework under which the hedge designation would focus on the sufficiency and probability of aggregate forecasted volumes, rather than requiring identification of specific cash flows by date or counterparty. Specifically, entities should be allowed to designate a portion of forecasted foreign currency-denominated income as the hedged item for foreign exchange risk alone, provided there is a sufficient volume of expected foreign-currency-denominated cash flows. There should not be a requirement to specifically identify whether the cash flows are floating or fixed interest rates because the variability being hedged is driven by foreign currency risk. This approach would allow for more accurate reflection of economic risk management objectives by mitigating foreign currency risk without requiring eliminating all sources of cash flow variability, such as interest rate risk. Expanding hedge eligibility in this way would improve alignment between accounting outcomes and real-world foreign exchange risk mitigation strategies.

If the view above is not acceptable, the Committee recommends removing any requirement to eliminate all variability in the hedged item's cash flows under a cash flow hedge throughout the guidance, including the requirement to remove all variability in the hedged item's functional-currency-equivalent cash flows. The cash flow hedge requirement should be limited to whether the derivative is highly effective in hedging the variability arising from the hedged risk.

Designate certain compound derivatives as net investment hedges

ASC 815-20-25-71(b)1 precludes entities from designating a compound derivative with multiple underlyings as a hedge of a net investment in a foreign operation:

> *815-20-25-71 Besides those hedging instruments that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedging instrument for the respective hedges:*
>
> d. *With respect to net investment hedges only:*
>
> 1. *A compound derivative instrument that has multiple underlyings—one based on foreign exchange risk and one or more not based on foreign exchange (for example, the price of gold or the price of an S&P 500 contract), except as indicated in paragraph 815-20-25-67 for certain cross-currency interest rate swaps*

The Committee recommends the Board reconsider this specific prohibition and align the accounting with the considerations espoused in the Proposed ASU - *Derivatives and Hedging (Topic 815) and Revenue from Contracts with Customers (Topic 606)* related to the assessment of predominant characteristics. While the Proposed ASU discusses this assessment in light of determining whether a contract qualifies for a derivative scope exception based on its predominant characteristics, the Committee believes the same concept should apply when assessing whether a derivative contract should be eligible to be designated as a net investment hedge because it predominately relates to foreign exchange risk.

For example, the increased inclusion of various environmental, social, and governance ("ESG")-linked metrics in derivative contracts. While these factors often can only have a de minimus impact on the cash flows and valuation of a derivative contract, they have resulted in derivative contracts being deemed to be compound derivatives and thus ineligible as net investment hedges.

In addition, certain accounting firms have also concluded that certain credit-mitigating features, such as Mandatory Early Termination ("MET") clauses, Optional Early Termination ("OET") clauses and forward-starting Credit Support Annexes ("CSAs"), effectively represent credit derivatives and thus would create compound derivatives when included as part of a foreign exchange derivative. Given the binary nature of the MET and OET features (i.e., they do not change the cash flows of a derivative but only call for termination at fair value), there is no conceptual reason a derivative with such a feature would not be a highly effective net investment hedge while active. Further, the

Committee notes that a CSA would represent a collateral arrangement that is separate from the derivative contract, and thus would not alter the critical terms of an otherwise highly effective hedging derivative. Further, this prohibition seems to serves no purpose or mitigation of abuse.

Amendment to Partial Term Definition

Currently, the partial term election cannot be applied to a financial instruments that are considered single cash flows, not consecutive cash flows.

> *Measuring the Change in Fair Value of the Hedged Item in Partial-Term Hedges of Interest Rate Risk Using an Assumed Term*
>
> *815-25-35-13B For a fair value hedge of interest rate risk in which the hedged item is designated for a partial term in accordance with paragraph 815-20-25-12(b)(2)(ii), an entity may measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term that begins when the first hedged cash flow begins to accrue and ends at the end of the designated hedge period. The assumed issuance of the hedged item occurs on the date that the first hedged cash flow begins to accrue. The assumed maturity of the hedged item occurs at the end of the designated hedge period. An entity may measure the change in fair value of the hedged item attributable to interest rate risk in accordance with this paragraph when the entity is designating the hedged item in a hedge of both interest rate risk and foreign exchange risk. In that hedging relationship, the change in carrying value of the hedged item attributable to foreign exchange risk shall be measured on the basis of changes in the foreign currency spot rate in accordance with paragraph 815-25-35-18. Additionally, an entity may have one or more separately designated partial-term hedging relationships outstanding at the same time for the same debt instrument (for example, 2 outstanding hedging relationships for consecutive interest cash flows in Years 1-3 and consecutive interest cash flows in Years 5-7 of a 10-year debt instrument).*

The Committee recommends that the Board consider revising the definition of "partial term" hedging under ASC 815 to better reflect the economics of hedging financial instruments with uncertain or non-periodic cash flows (such as zero-coupon bonds and loan commitments).

Under current guidance, ASC 815-25-35-13B allows entities to apply a partial-term fair value hedge using an assumed term that begins when the first hedged cash flow begins to accrue and ends at the end of the designated hedge period. However, this model assumes a contractual schedule of periodic interest payments, which may not exist for instruments like loan commitments or zero-coupon bonds. As a result, such items may not qualify for the partial-term election or portfolio designation, despite being economically exposed to interest rate risk like other instruments with periodic cash flows. For example, fixed-rate loan commitments may expose the lender to interest rate risk from the time the commitment is issued even though the actual loan may not be drawn until later. Similarly, zero-coupon bonds contain a fixed-rate component but do not have periodic payments. These instruments cannot currently apply the partial term hedging election due to the current restrictions.

The Board should consider amending the partial-term hedging framework to permit designation based on the timing of expected (rather than contractual) cash flows. As discussed above related to improvements to the accrual-based hedging model, the hedge accounting model should not focus on the timing of cash flows but the economic impact. Instruments like zero-coupon bonds and fixed-rate loan commitments accrue value over time and are commonly hedged based on those exposures, even when there is not periodic cash flows. This would allow hedge accounting to better align with actual risk exposures and improve the representational faithfulness of hedges of loan commitments and similar instruments.

Translation risk associated with foreign-currency denominated subsidiaries

The forecasted earnings or expenses of a foreign subsidiary are subject to translation risk, but there is an inability to hedge this risk. ASC 815-20-25-23 precludes a parent entity from hedging revenues or expenses occurring at a subsidiary level when those revenues or expenses are denominated in the subsidiary's functional currency. For example, a US Dollar ("USD") parent cannot designate Euro ("EUR") revenue or expenses recorded by a subsidiary whose functional currency is EUR, despite the economic risks.

ASC 815-20-25-23 Under the functional currency concept of Topic 830, exposure to a foreign currency exists only in relation to a specific operating unit's designated functional currency cash flows. Therefore, exposure to foreign currency risk shall be assessed at the unit level.

ASC 815-20-25-24 A unit has exposure to foreign currency risk only if it enters into a transaction (or has an exposure) denominated in a currency other than the unit's functional currency.

ASC 815-20-25-25 Due to the requirement in Topic 830 for remeasurement of assets and liabilities denominated in a foreign currency into the unit's functional currency, changes in exchange rates for those currencies will give rise to exchange gains or losses, which results in direct foreign currency exposure for the unit but not for the parent entity if its functional currency differs from its unit's functional currency. 815-20-25-30 Both of the following conditions shall be met for foreign currency cash flow hedges, foreign currency fair value hedges, and hedges of the net investment in a foreign operation:

a. *For consolidated financial statements, either of the following conditions is met:*
    1. *The operating unit that has the foreign currency exposure is a party to the hedging instrument.*
    2. *Another member of the consolidated group that has the same functional currency as that operating unit is a party to the hedging instrument and there is no intervening subsidiary with a different functional currency. See guidance beginning in paragraph 815-20-25-52 for conditions under which an intra-entity foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.*
b. *The hedged transaction is denominated in a currency other than the hedging unit's functional currency.*

ASC 815-20-25-27 Because a parent entity whose functional currency differs from its subsidiary's functional currency is not directly exposed to the risk of exchange rate changes due to a subsidiary transaction that is denominated in a currency other than a subsidiary's functional currency, the parent cannot qualify for hedge accounting for a hedge of that risk. Accordingly, a parent entity that has a different functional currency cannot qualify for hedge accounting for direct hedges of a subsidiary's recognized asset or liability, unrecognized firm commitment or forecasted transaction denominated in a currency other than the subsidiary's functional currency. Also, a parent that has a different functional currency cannot qualify for hedge accounting for a hedge of a net investment of a first-tier subsidiary in a second-tier subsidiary.

A common risk management practice for multi-currency entities is to look at net foreign exchange risk exposure generated by foreign subsidiaries. For example, when a parent company has USD functional currency and consolidates a subsidiary with a Euro functional currency, the parent is exposed to Euro foreign exchange risk. The subsidiary is not able to hedge the foreign currency exposure related to the subsidiary's Euro denominated sales because Euro is its functional currency, and the parent is limited to hedging the risk through a net investment hedge related to a EUR subsidiary's operations. and cannot hedge the foreign currency ("FX") revenue because it is not directly exposed to the exchange rate risk.

In practice, multinational companies regularly hedge this type of consolidated translation risk. The risk management objective is to lock in the USD-equivalent of forecasted foreign-currency-denominated revenue or expenses based on the prevailing forward and spot rates. Although in some scenarios the hedge can economically mitigate this risk, there can be volatility in P&L because of a timing mismatch. The change in fair value of the derivative is recognized in P&L once it has been entered but the translation risk does not affect earnings until the following period or the period the forecasted transaction occurs.

For purposes of consolidated reporting, hedge accounting should be permitted to be applied at the parent level to hedge the foreign currency risk for subsidiaries that are consolidated for financial reporting. The Committee suggests modifying ASC 815-20-25-27 to allow a scope exception related to how foreign currency risk is assessed. When determining whether a foreign currency risk exists, the assessment could be performed based on the functional currency of the reporting entity or the parent. In order to support this type of hedge relationship, the Committee suggests a requirement could be added to include in the day 1 documentation that the risk being hedged is related to the parents' foreign currency risk. Additionally, this would not be 'double-hedged' at a consolidated level because the subsidiary is prohibited for hedging the foreign currency risk from its own functional currency.

Repricing and payment date differences when using the 'long-haul' method

The guidance around hedge effectiveness criteria applicable to both fair value and cash flow hedges addresses mismatches that can occur between the hedged item and hedging instrument. Specifically, within ASC 815-20-25-77:

> *ASC 815-20-25-77 There would be a mismatch between the change in fair value or cash flows of the hedging instrument and the change in fair value or cash flows of the hedged item or hedged transaction in any of the following circumstances, among others:*
>
> *a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction, to the extent that those bases do not move in tandem*
>
> *b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in any of the following:*
> 1. *Notional amounts*
> 2. *Maturities*
> 3. *Quantity*
> 4. *Location (not applicable for hedging relationships in which the variability in cash flows attributable to changes in a contractually specified component is designated as the hedged risk)*
> 5. *Delivery dates.*
>
> *c. A change in the counterparty's creditworthiness.*

The Big 4 accounting firms' interpretative guidance indicates that any terms affecting the timing and amount of cash flows are deemed critical terms of the instruments. This means a mismatch between the payment date of the loans and the hedging instrument would be considered a mismatch between the hedging instrument and the hedged item, requiring a quantitative hedge effectiveness assessment. The same rationale applies to differences in repricing dates for variable rate loans. For example, when hedging interest receipts on variable rate loans which reference one month Term SOFR and the hedging instrument swaps one month Term SOFR for a fixed rate, if there are payment date differences between the loan and the pool, a quantitative hedge effectiveness assessment must be performed. When hedging a pool of loans, this means testing various payment dates on the loans as part of the hedge effectiveness assessment. The time value differences between payment dates and the repricing interval rarely ever results in being a contributing factor in a failure of the hedge effectiveness assessment.

The Committee suggests modifying all cash flow hedge accounting guidance to allow companies to ignore the repricing interval and payment date differences as long as the dates are within one year as such period would rarely result in a failure in the hedge effectiveness assessment. This amendment removes the operational burden associated with executing these types of hedges.

Shortcut method criteria

Similar to the issue above, there is an interpretation from the Big 4 accounting firms that appears to be a more stringent interpretation of the criteria than what is described in the guidance. The shortcut method for interest rate swaps requires all of the formal hedge documentation at inception, but it requires no ongoing assessment of hedge effectiveness if all of the criteria for its use are met at the inception of the hedge. This relieves much of the complexity and operational burden of performing quantitative assessments both at inception and on an ongoing basis. The criteria includes:

> *ASC 815-20-25-104 All of the following conditions apply to both fair value hedges and cash flow hedges:*
>
> *d. The formula for computing net settlements under the interest rate swap is the same for each net settlement. That is, both of the following conditions are met:*
>
> > *1. The fixed rate is the same throughout the term.*
> >
> > *2. The variable rate is based on the same index and includes the same constant adjustment or no adjustment. The existence of a stub period and stub rate is not a violation of the criterion in (d) that would preclude application of the shortcut method if the stub rate is the variable rate that corresponds to the length of the stub period.*

g. Any other terms in the interest-bearing financial instruments or interest rate swaps meet both of the following conditions:

1. The terms are typical of those instruments.

2. The terms do not invalidate the assumption of perfect effectiveness

There is an interpretation among audit firms based on discussions with the FASB staff that forward-starting interest rate swaps are not considered to have a consistent formula for computing net settlements, because the settlements occur only after the effective date and not between the trade date and effective date. However, the guidance does not suggest that this was the FASB's intention.

There is an inconsistent application where a spot-starting partial-term hedge would qualify under the shortcut method, whereas a forward-starting partial-term hedge would not qualify. The FASB could resolve this interpretation by providing clarification that the shortcut method can be applied while using a forward-starting swap. The Committee believes the FASB has to provide an explicit interpretation of the guidance stating that forward-starting swaps are not considered to have an inconsistent pricing formula for computing net settlement in order to refute the Big 4 accounting firms interpretation.

Ability to designate non-derivative instruments as hedges

There are recognition and measurement differences between various types of financial instruments presented on the balance sheets of financial institutions. However, pursuant to ASC 815-20-25-58, non-derivative instruments are not permitted to be used as hedging instruments:

A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Topic 830 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in Subtopic 815-25 if all the fair value hedge conditions in this Section and the conditions in paragraph 815-20-25-30 are met.

ASC 815-20-25-71 Besides those hedging instruments that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedging instrument for the respective hedges:

a. With respect to fair value hedges, cash flow hedges, and net investment hedges:
   - *i) A nonderivative instrument, such as a U.S. Treasury note, except as provided in paragraphs 815-20-25-58 through 25-59 and 815-20-25-66*

b. With respect to fair value hedges only:
   - *i) A nonderivative financial instrument as the hedging instrument in a fair value hedge of the foreign currency exposure of a recognized asset or liability.*
   - *ii) A nonderivative financial instrument as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale debt security.*

c. With respect to cash flow hedges only:
   - *i) A nonderivative financial instrument as a hedging instrument in a foreign currency cash flow hedge.*

The Committee suggests the Board remove ASC 815-20-25-71(a)i, 25-71(b)i and 2, and 25-71(c)i. The risks on different items on the balance sheet may present offsetting exposures across interest rate risk or foreign currency risk. Therefore, there may be many opportunities for entities to achieve hedge accounting using non-derivative instruments. The Committee suggests the Board remove the prohibition on using non-derivative financial instruments as the hedging instrument.

Question 3: Are there financial accounting and reporting topics in this ITC that the Board should *not* address as part of its future standard-setting efforts? Please explain why not, such as there is no pervasive need to change GAAP, the scope would not be identifiable, or the expected benefits of potential solutions would not justify the expected costs.

As discussed under Question 42 in Chapter 6 below, the Committee does not believe there is a pervasive need to revise the current guidance in ASC 310-20 related to the recognition of interest income using the effective interest method.

While the committee acknowledge that certain stakeholders may find this guidance complex or less decision-useful in specific scenarios—such as large pools of prepayable mortgage loans—the Committee's members have not encountered broad-based issues in practice that would warrant standard-setting in this area. See responses below in Chapter 6 for detail.

The Committee recommends that the Board not undertake standard-setting to develop a single consolidation model that combines the variable interest entity ("VIE") and voting interest models. While the objective of simplification is understandable, the current consolidation framework under ASC 810 is operational in practice and well understood. Introducing a single model may result in significant implementation complexity without a clear improvement in decision-useful information. The Committee does not believe a pervasive need exists to justify the scope and cost of this project.

The Committee also recommends that the Board not codify the Hypothetical Liquidation at Book Value ("HLBV") method. HLBV is a specialized approach that has developed through industry practice to address certain investment structures, such as those in renewable energy. Making it part of formal guidance could unintentionally limit how it's applied or lead to it being used in situations where it may not fit. Current guidance already provides enough flexibility, and any further consideration of HLBV should be addressed through continued engagement with industry stakeholders rather than formal standard-setting.

The Committee encourages the Board to focus its resources on the highest-impact projects—particularly those that address long-standing hedge accounting challenges—as outlined under the response to Question 2.

Question 4: Are there any financial accounting and reporting topics beyond those in this ITC that should be a top priority for the Board to address? Please explain, including the following:

a. **The nature of the topic**
b. **The reason for the recommended change**
c. **Whether the topic is specific to a subset of companies, such as public companies, private companies, or NFPs, or specific to a certain industry**
d. **How the Board should address this topic (that is, the scope, objective, potential solutions, and the expected benefits and expected costs of those solutions)**
e. **What is the urgency to complete standard setting on this topic (that is, how quickly the issue needs to be addressed).**

Refer to the Committee's response under Question 2 for the topics that should be a top priority for the Board to address.

<u>Chapter 2 – Financial Instruments</u>

Distinguishing Liabilities from Equity

Question 13: If the FASB were to make targeted improvements to the liabilities and equity guidance in Subtopic 815-40, would you support those changes if they significantly changed current financial reporting outcomes? For example, would you support accounting for more contracts indexed to an entity's own equity as equity as compared with today? Please explain.

The Committee appreciates the work that the FASB's Emerging Issues Task Force ("EITF") has done with respect to emerging issues for liabilities and equity. However, the Committee does not believe the Board should prioritize projects related to the accounting for contracts indexed to an entity's own equity or other targeted improvements to the liabilities and equity guidance. Existing GAAP is sufficiently clear and practice has developed on how to analyze complex instruments. As such, the Committee does not believe there is any need to further refine or provide targeted improvements because the current guidance generally results in accounting that is consistent with the economics of transactions, and the Committee does not believe there are pervasive inconsistencies in applying the guidance.

Question 14: What targeted improvements, if any, to the liabilities and equity guidance in Subtopic 815-40 should the FASB consider making? For example, should the improvements focus on the indexation guidance in the Scope and Scope Exceptions Section of Subtopic 815-40, the settlement guidance in the Recognition Section of Subtopic 815-40, or both? Please explain.

As noted above, the Committee does not believe targeted improvements for the liabilities and equity guidance in Subtopic 815-40 should be a priority for the FASB.

Risk Management and Hedge Accounting

Question 15: Should the FASB consider revising the hedge accounting model? If so, what core aspects of the hedge accounting model should be amended or removed to allow hedge accounting to more accurately reflect the economics of an entity's risk management activities? Please describe why and how those core aspects should be amended or why they should be removed.

The Committee would strongly support the FASB undertaking revisions to the hedge accounting model. As previously described in the Committee's whitepaper, *Hedge Accounting Under US GAAP* (July 2024), and again reiterated in Question 2 above, the Committee emphasizes the need for amendments to ASC 815 to better align the accounting results for entities risk management activities using derivatives and hedging with the actual intent of the risk management practices used across financial and non-financial entities. While ASC 815 has provided a workable framework, certain restrictions and interpretations limit the ability of institutions to employ hedge accounting in a manner that aligns the accounting with the risk management intentions. The Committee strongly recommends the FASB prioritize a comprehensive review and amendment of the critical areas of hedge accounting. An improved hedge accounting model could considerably improve the alignment between risk management activities and financial reporting outcomes, reduce complexity, enhance transparency, and increase the relevance of financial information presented to investors and stakeholders.

As described under question 2, the Committee believes improvements could be made to the hedge accounting model either through a holistic review or through a series of targeted improvements that can address the issues identified and summarized by the principle in ASC 815.

Question 16: Should the FASB consider changing hedge accounting disclosures? If so, what changes could be made to hedge accounting disclosures and how would they better portray the economics of an entity's risk management activities? Please explain.

The Committee does not believe that new disclosures are needed for economic risk management activities that do not qualify for hedge accounting under ASC 815. While strategies like managing interest rate or foreign currency risk are important, they are better explained in Management's Discussion and Analysis ("MD&A"), not in the financial statement disclosures.

This view is supported by of EY Derivatives and Hedging guide[3] section 8.6.4, which references ASC 815-10-50-4CC which notes that "entities have different views about what constitutes an 'economic' hedging relationship, so the disclosure of any derivative/ 'hedged item' pairings that are not in formal ASC 815 hedging relationships is prohibited." That guidance makes clear that companies have different views on what counts as an "economic" hedge, and so disclosures should only include formally designated hedge relationships. Requiring disclosures for economic hedges would create inconsistency and add unnecessary complexity to financial reporting. The Committee believes the current disclosure approach is appropriate and helps keep a clear line between accounting hedges and general risk management. The Committee encourages the Board to maintain the current scope of hedge accounting disclosures and avoid introducing requirements that could make it hard to distinguish between formal hedge accounting and general risk management strategy.

The Committee also refers the Board to our response to Question 45 (Outdated Disclosures), where the Committee points out that some current hedge-related disclosures—like those for cumulative basis adjustments and reclassifications from AOCI—which already present challenge from a cost benefit perspective and may no longer be decision-useful to users. Before adding new disclosures, the Committee suggests the Board first reassess and address some of these existing disclosures.

Definition of a Derivative and Derivative Modifications

[3] Ernst & Young LLP, Financial Reporting Developments: Derivatives and Hedging (ASC 815) (EY, 2024).

Question 19: Regarding derivative accounting, what other challenges (beyond those that would be addressed in the 2024 proposed Update on derivative scope refinements), if any, do you encounter in practice? Please explain.

The Committee supports the Board's efforts to improve the application of the definition of a derivative andderivatives scope exceptions to arrangements with contingent features, and excluding from derivative accounting contracts with underlyings that are based on the operations or activities of one of the parties to the contracts.

The Committee does not have any additional comments on this topic beyond those already provided in the Committee's comment letter on the FASB's 2024 proposed Update on derivative scope refinements. That letter outlines the Committee's views on the key challenges and recommendations related to derivative accounting. the Committee appreciates the Board's ongoing work in this area and have no incremental input to offer at this time.

Question 20: There is currently a project on the research agenda that includes the accounting for derivative contract modifications. If the FASB were to prioritize a project on derivative modifications, what approach should be applied to assess and account for the modification of a derivative? Please explain.

As included above in Question 1 (subtopic 'Derivative Modifications'), existing US GAAP is unclear on the application of Topic 815 to modified derivatives and specifically interest rate and foreign currency derivatives. Entities modify interest rate derivative contracts in a variety of ways and for a variety of reasons. As discussed above, the Committee believes that a qualitative assessment should first be performed to determine if any quantitative assessment is required. For example, if an entity's intention is to continue to account for the instrument as a derivative, there should be a presumption that the instrument will continue to be a derivative

Additionally, an entity will need to consider whether the future cash flows on the amended derivative should be reported in the financing section of the statement of cash flows (rather than operating cash flows). ASC 815-10-45-12 requires entities to report all cash flows associated with a derivative that contains an other-than-insignificant financing element at its inception as "cash flows from financing activities" in the statement of cash flows. This requirement relates to all cash flows from the derivative and not just the portion of the cash flows relating to the financing element of the derivative. Therefore, the periodic cash flows over the life of the derivative, as well as any cash flow at its inception, would be treated as cash flows from financing activities. The Committee believes that rather than applying DIG A23 by analogy to such transactions, the Board should consider standard setting for when and how a quantitative derivative modification assessment needs to be applied to derivatives. This would also potentially prevent financial reporting outcomes that do not produce decision useful information. For example, when modified derivatives fail the DIG A23 test today and entities elect the fair value option (which financial institutions frequently do in this outcome), cash flows are presented in the "financing activities" section of the statement of cash flows, the change in fair value due to "own credit risk" is required to be calculated and recorded in other comprehensive income, and the hybrid instrument is subject to the fair value disclosures of ASC 820 and ASC 825.

Transfers and Servicing of Financial Assets

Question 23: If the FASB were to pursue a project to consider improvements to Topic 860, what issues or transactions should it address? For those issues, please explain the challenges encountered in practice when applying the current guidance and what improvements should be considered.

While the Committee's primary focus for this comment letter is on derivatives and hedge accounting, the Committee recognizes that there are also areas for improvement within Topic 860, Transfers and Servicing, which are closely linked to the financial instruments and structured transactions used by ISDA members. Many members of this Committee also participate in other industry groups, such as the SIFMA accounting committee, who are also providing responses to the ITC and addressing issues with Topic 860. The Committee is supportive of these industry groups comment letters.

<u>Chapter 6—Income and Expenses</u>

Recognition of Interest Income

Question 42: How should interest income for loans within the scope of Subtopic 310-20 be subsequently recognized? Please explain.

The Committee does not believe there is a pervasive need to revise the current guidance in ASC 310-20 related to the recognition of interest income using the effective interest method. While the Committee acknowledges that certain stakeholders may find this guidance complex or less decision-useful in specific scenarios—such as large pools of prepayable mortgage loans—the Committee's members have not encountered broad-based issues in practice that would warrant standard-setting in this area.

The Committee notes that the effective interest method already provides a consistent framework for recognizing income on loans over time and in our experience, users generally understand the timing and pattern of income recognition under the existing model, and preparers are able to apply it without undue burden.

Accordingly, the Committee does not believe this issue should be a priority for the Board at this time. However, the Committee encourages the Board to continue engaging with stakeholders in specialized industries where alternative models may be more relevant and consider clarifying guidance if significant diversity in practice is observed.

Chapter 7—Presentation and Disclosure of Financial Reporting Information

Outdated Disclosures

Question 45: Are there current disclosure requirements that do not provide meaningful information about an entity? If yes, please explain which disclosures are not decision useful and whether those disclosures should be removed or how they should be improved.

The Committee appreciates the FASB's efforts to improve financial disclosures and reduce unnecessary complexity. The Committee believes some current disclosure requirements—particularly those related to derivatives, guarantees, VIEs, and hedge accounting—no longer provide useful information to investors. In many cases, these disclosures are costly and difficult to prepare, and the information they provide is not helpful for understanding a company's risk or financial position. Below, the Committee highlights several disclosure areas that the Board should consider removing or simplifying.

Level 3 roll forward: ASC 820-10-50-2(bbb) and 820-10-50-2(c)

The Committee believes the Board should revisit the disclosure requirements for Level 3 derivatives under ASC 820-10-50-2(bbb) and 820-10-50-2(c). These provisions require a detailed roll-forward of recurring Level 3 fair value measurements, including purchases, issuances, settlements, and gains or losses each period. For banks with large, customized portfolios of derivatives, this level of tracking is highly burdensome. As illustrated in Chapter 6 of EY's Derivatives and Hedging Guide[4], even a single interest rate cap strategy can involve detailed tracking of time and intrinsic value monthly. These requirements often require manual workarounds, as systems are not designed to automate disclosures at this level of detail.

In practice, financial statement users often do not find these disclosures helpful. Without context on valuation techniques or how the instruments relate to the entity's overall risk management objectives, the data can appear disconnected and overly technical. The Committee recommends the Board reconsider whether these disclosures remain necessary, particularly for immaterial Level 3 positions, and explore ways to simplify or remove them where they provide limited decision-useful value relative to the cost/benefit of providing such disclosures.

Derivatives that are guarantees (Credit Derivatives): ASC 815-10-50-4J through 4L

The Committee encourages the Board to reassess the disclosure requirements for credit derivatives that function as guarantees under ASC 815-10-50-4J through 4L. These paragraphs require sellers of credit protection to disclose detailed information on the nature and terms of credit derivatives, the reason for entering into the credit derivative, events and circumstances that would require the seller to perform under the credit derivative, payment risk status, maximum potential future payments, and collateral arrangements. While intended to provide transparency, these disclosures often result in detailed tabular data that is operationally burdensome to prepare and of limited relevance to users of financial statements.

Many institutions that issue or hold credit derivatives manage them in high volumes across varied legal forms, including embedded features in structured products. Tracking this level of disclosure detail—particularly grouping by

[4] Ernst & Young LLP, Financial Reporting Developments: Derivatives and Hedging (ASC 815) (2024, Ernst & Young LLP)

contract type and referenced asset class—requires significant manual effort, as system capabilities are not always designed to capture and report this granularity. For example, ASC 815-10-50-4L goes on to suggest presenting the disclosures by major contract types (e.g., single-name credit default swaps, traded indexes, portfolio products, swaptions) and further disaggregating by referenced asset classes (e.g., corporate debt, sovereign debt, structured finance). For hybrid instruments with embedded credit derivatives, the standard requires disclosure of the entire hybrid instrument rather than just the embedded feature. This level of required detail is often impractical to implement and goes beyond what is useful to financial statement users.

Users often do not find these disclosures decision-useful, as the maximum potential payment figures do not reflect actual risk and are often disconnected from fair value measures that already incorporate credit exposure.

The Committee recommends that the Board consider eliminating or simplifying these disclosure requirements. Reducing redundant or low-value disclosure obligations would help relieve unnecessary complexity and ensure that disclosures remain focused on conveying relevant, decision-useful information to users.

VIEs: ASC 810-10-50-4 through 50-5A

The Committee recommends that the Board reassess the disclosure requirements under ASC 810-10-50-4 through 50-5A for entities involved with, but not consolidating, VIEs. These requirements call for a high level of detail, including tabular disclosures of carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position that relate to the reporting entity's variable interest in the VIE. They also require disclosures of the maximum exposure to loss, along with narrative explanations of the nature of involvement and support provided. In practice, this level of disclosure is costly to produce, operationally burdensome, and of limited usefulness to financial statement users, especially for VIEs that are not consolidated.

Many reporting entities have VIEs that will never result in consolidation—for example, through retained interests or passive arrangements where the entity does not and cannot gain power over the significant activities of the VIE. Requiring full disclosures for these VIEs may not reflect actual risk. The Committee believes the disclosure framework should focus on VIEs that are consolidated, with a simplified schedule and qualitative disclosures for unconsolidated VIEs. This would provide users with relevant information on risk exposure without the current extensive disclosure reporting requirements.

Cumulative basis adjustment: ASC 815-10-50-4EE

The Committee also recommends that the Board remove the disclosure requirement under ASC 815-10-50-4EE, which requires entities to present a cumulative basis adjustment table for fair value hedges. While the Committee understands that the Board believes these disclosure helps users evaluate the amount, timing, and uncertainty of prospective cash flows associated with the hedged items, the Committee does not believe the requirement achieves that objective in the best way.

Specifically, the table requires disclosure of the carrying amount of hedged assets and liabilities, cumulative basis adjustments to those items, the related balance sheet line items, and adjustments remaining from discontinued hedges. However, in practice, these disclosures are difficult to produce and operationally burdensome—particularly for financial institutions managing a high volume of hedged items or using portfolio hedging strategies. Further, the information often lacks decision-usefulness. Although the disclosures aim to show how hedging affects future cash flows, they mainly reflect past changes in interest rates and the cumulative amount of fair value hedging adjustments to hedged assets and liabilities. This makes them less decision useful for understanding future earnings or cash flows, especially when hedging has been discontinued.

Cash flow hedge – amount reclassified from AOCI to earnings: ASC 815-30-50-1(c)

The Committee recommends that the Board reevaluate the disclosure requirement under ASC 815-30-50-1(c), which requires entities to disclose the estimated net amount of gains or losses in accumulated other comprehensive income ("AOCI") expected to be reclassified into earnings within the next 12 months. While intended to help users understand the timing of hedge accounting effects on earnings, this disclosure often does not provide decision-useful information and can be operational burdensome to produce.

In practice, meeting this disclosure requirement requires entities to apportion the net gain or loss in AOCI to each of the hedged forecasted transactions, which can be numerous, variable in timing, and interrelated. The standard does not specify how this apportionment should be done or whether the estimate should be based on discounted or undiscounted amount, resulting in inconsistent application across entities. This lack of guidance makes the disclosure difficult to interpret and reduces comparability for users.

Additionally, the disclosure requirement does not distinguish between "live" hedges, where AOCI balances continue to change and the disclosure is truly an estimate, and terminated hedges, where the AOCI balance is frozen and runs off through the income statement. Applying the same disclosure to both situations adds complexity and may confuse users, since one is based on a changing estimate and the other can be tied to fixed, predictable amounts.

For these reasons, the Committee believes that this disclosure should be removed or revised entirely.

Chapter 8— Current Research Agenda Projects

Statement of Cash Flows

Question 52: Should the FASB pursue a project on the statement of cash flows? If yes, which improvements, if any, are most important? Should the FASB leverage the current guidance in Topic 230, Statement of Cash Flows? If yes, would it be preferable to retain the direct method, the indirect method, or both? Should this potential project be a broad project applicable to all entities that provide a statement of cash flows or limited to certain entities or industries? Please explain.

The Committee believes that targeted improvements to the Statement of Cash Flows ("SoCF") may be useful in some sectors, but caution against broad-based changes, particularly those that would require the direct method or make large changes to existing presentation requirements. This is especially relevant for financial institutions, for which the indirect method remains the most practical and meaningful approach.

The indirect method is widely used in practice and should be retained. It provides a meaningful linkage between the income statement, balance sheet, and operating cash flows. As noted in the EY ASC 230 Statement of Cashflows guide[5], although ASC 230 encourages the use of the direct method, the indirect approach "provides a useful link to income statements and balance sheets, is more familiar to financial statement users and generally is the less costly approach to prepare."

For financial institutions, the indirect method is particularly advantageous. These entities often engage in complex financial transactions involving interest income, non-cash derivatives, and securities activity that do not align neatly with gross cash receipts and payments. Attempting to present these transactions using the direct method would be not only operationally burdensome but potentially less meaningful to users.

Given the nature of financial services, there will always be limits to the usefulness of the SoCF. The Committee agrees it would make sense to reflect financial institutions businesses in operating but believes the SoCF itself would be of limited usefulness. Given there is such limited use of the SoCF in general, the Committee questions whether it is even needed for financial institutions and if it is, to carefully consider the cost-benefit considerations before making any changes.

Accounting for Commodities

Question 53: Should financial institutions that hold physical commodities for trading purposes be permitted to apply the fair value option? Please explain, including whether and how providing an option would provide decision-useful information.

Executive Summary:

The Committee believes the Board should consider expanding the scope of the fair value option ("FVO") that is provided under Topic 825, *Financial Instruments*, to include physical commodity inventories as well as executory contracts related to physical commodities (e.g., storage, transportation, non-derivative purchase or sale contracts) that are (1) managed on a fair value basis[6]. Given the challenges and significant operational cost that exist with applying fair value hedge accounting to the substantial majority of these positions, entities continue to experience mark-to-

[5] Ernst & Young LLP, Financial Reporting Developments: Statement of Cash Flows (ASC 230) (Ernst & Young, 2024)

[6] This concept would be consistent with the same under IAS 39 and IFRS 9 (e.g., manage and evaluate performance on a fair value basis, in accordance with a documented risk management or investment strategy). For example, this would include where positions are economically hedged and risk managed collectively, including as part of trading and market making businesses.

market volatility related to legitimate risk management activities and, therefore, having an option to measure certain physical commodity inventories as well as related executory contracts at fair value would provide a practical and simplified solution. Currently, only entities following specialized accounting guidance such as the *AICPA Audit and Accounting Guide: Brokers and Dealers in Securities* ("B/D Guide") or Investment Companies are permitted to account for these types of contracts at fair value under US GAAP. The Committee believes this issue is pervasive, and absent a fair value option election, entities will continue to report volatility in earnings that are not consistent with their actual economic position and incur operational costs that could be avoided through the fair value option. Further, providing entities with the ability to elect the fair value option is in line with the objective of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. If the FASB does not believe the fair value option can be expanded, the Committee has proposed an alternative to simplify the hedge accounting framework for non-financial assets.

Committee response to question 53:

There are significant challenges and operational costs when attempting to apply fair value hedge accounting to commodities and executory contracts. As a result, the mark-to-market volatility introduced when attempting to hedge these positions in line with a companies risk management practices. This volatility is reflected in the financial statements of the preparers. The Committee recommends the Board address this accounting mismatch by allowing the fair value option of these contracts, or simplify the hedge accounting model to allow companies to align the economics of their risk management practices in the financial statements.

Accounting mismatch

Inventory

Entities that hold and engage in a significant level of transactions involving physical commodities typically maintain an economically hedged or "matched" book of business wherein they hold futures and other derivatives contracts against certain portions of their physical commodity inventory. Given the nature of these hedging instruments, the "normal purchases and sales" scope exception in ASC 815, *Derivatives and Hedging* ("ASC 815") generally does not apply (as opposed to managing risk through fixed-price physically-settled purchase and sale contracts) and are therefore generally accounted for as derivatives and measured at fair value. Further, fair value hedge accounting is often difficult to apply (see below for further discussion). As a result, where fair value measurement of the physical commodity inventory is not permitted, the net economic exposure for all outstanding activities is not appropriately captured in the financial statements because there are accounting mismatches that result in gains/losses that are not consistent with the economics of the activity. Further, the Committee believes that measuring physical commodity inventory at fair value better reflects the expected economic outcome and future cash flows than the lower of cost or net realizable value. In addition, hedge accounting requirements are burdensome and expensive, especially for inventory that changes daily and must be de-designated, redesignated, reassessed for effectiveness, and documented on a daily basis.

Executory Contracts

In addition to holding physical commodity inventory, entities also enter into arrangements that provide for the right or obligation to transport and/or store those commodities which do not meet the definition of a derivative and are accounted for on an accrual basis. Given location, seasonality and time can impact the current and future values of the commodities that correspond to these arrangements, it is generally the case that these arrangements can have value where, for example, the differential between the prices of a commodity at points A and B exceed the fixed and variable costs associated with the arrangement. As a result, these arrangements can be thought of as various forms of basis contracts, and to that end, it is not uncommon for entities to economically hedge their exposure to such arrangements by, for example, entering into futures contracts aligned with the points of receipt and delivery.[7] Similar to hedges of physical commodity inventory outright, historically it has been challenging to achieve hedge accounting for these risk

[7] For example, assume an entity has the obligation to ship natural gas from point A to point B for $0.10 per MMBtu. If the price to purchase natural gas at point A is $2.00 and the price to sell natural as is $2.10, simplistically, the contract would have no intrinsic value. However, if the price at point B increases, the contract would have positive intrinsic value as the entity would buy natural gas for $2.00, pay $0.10 to ship and then sell for an amount greater than the total "cost" of $2.10. Given the potential volatility associated with these arrangements (positive or negative) an entity may choose to financially hedge their exposure, for example, by entering into a fixed-price derivative to purchase at point A and a fixed-price derivative to sell at point B (or this may be combined into a basis swap as a function of the differential between these two locations).

management activities for various reasons and, therefore, these entities generally have experienced earnings volatility which is not reflective of the overall economics of its activities. For example, as a result of market dynamics associated with the availability of storage capacity for certain commodities as a function of the initial responses to the COVID-19 pandemic, it may have been that an entity hedged its storage arrangement at a time when there was significant positive value. As markets stabilize and the value of storage declines, the entity generally would have then recognized mark-to-market gains on their hedges that were not offset by mark-to-market losses on the storage arrangement despite having potentially meaningful *economic* losses. This approach is not meaningful or transparent to investors and other users of the financial statements as compared to the proposal.

Fair value hedge accounting

While the Committee believes allowing fair value treatment of commodities through the fair value option would be preferable, as noted above, another option historically considered is the application of fair value hedge accounting. Given that Topic 815 does not have a concept of focusing only on the "benchmark" components of nonfinancial assets in fair value hedging context (e.g., price of commodities deliverable into highly liquid exchange-traded contracts), it is often difficult to apply these rules in practice as some form of basis typically exists in the relationship. For example, physical commodity inventory may be held at a location and/or have physical attributes (e.g., purity, grade) that differ to the commodities underlying financial indices and, therefore, the correlation of the relationship suffers. And while this basis may not be significant enough to preclude hedge accounting as a technical matter, the cost of administering such relationships is often prohibitive given the requirements to model and quantitatively assess the basis, which may also require frequent rebalancing and adjusting hedge ratios to maintain effectiveness (i.e., if not disaggregating portfolios by grade, etc., which itself can be operationally challenging). Alternatively, entities could execute bespoke derivative contracts to address basis, but this is often cost prohibitive and is an uncommon risk management strategy in general.

Even where basis can be addressed (i.e., through additional administration and/or bespoke arrangements), as fair value hedge accounting only permits identifying *closed* portfolios, it can remain administratively burdensome to maintain relationships where, for example, inventory turnover is more elevated. Further, it can be an onerous, sometimes manual process to track historical cost basis and hedge basis adjustments at the individual unit level to support certain financial statement disclosures. Also, complexities arise with regard to tracking these items in the context of intercompany sales, where different outcomes may arise for standalone and consolidated reporting purposes. As a result, often times it is the case that entities forego hedge accounting altogether, and in certain cases will disclose non-GAAP measures to the extent the accounting mismatch is significant.

The Committee believes a preferable outcome would be to amend the accounting rules to allow for measurement at fair value so that the full economics of these risk management activities is made clear and transparent to users of the financial statements. That is, under the current framework, valid economic hedging activities create an accounting mismatch and, therefore, the users of the financial statements only see one side of the equation (i.e., earnings volatility despite having offsetting risk). However, if entities were permitted to measure both the commodity position and its economic hedge at fair value, the net risk is more clear and any lack of precision with the entity's risk management strategies would be more transparent to users real-time, as well as the cost of such strategies. This approach acknowledges that the fair value option and fair value hedge accounting are ultimately driving at the same goal of addressing accounting mismatches and reporting a more accurate representation of the entity's exposure as well as the effects of their risk management activities – but reduces the operational burden and practical "hurdles" to achieving this outcome that are inherent in the hedge accounting alternative. Further, it aligns the accounting models for financial and certain non-financial assets where the objectives of each portfolio may be virtually identical from the preparer's perspective.

Pervasiveness

Some financial institutions hold physical commodity inventory for proprietary trading and market making activities in entities that apply the B/D Guide and, therefore, are generally able to fair value such positions. However, this does not necessarily capture executory contracts related to physical commodities, and it is more common that physical commodity inventory and/or related executory contracts are held in entities that do not apply the B/D Guide (e.g., depository and lending institutions holding precious metals). Even for entities that do apply the B/D Guide, there could still be executory contracts that might not get fair value treatment (for example transportation type contracts) and there is diversity in practice in whether those contracts are accounted for at fair value. Outside of financial institutions, as entities across many industries have increased focus on the environmental impact of their businesses, they often seek to execute transactions related to renewable energy. While it may be possible to avoid an accounting mismatch for certain transactions, the Committee observes some entities engaging in a broader range of activities, including hedging the value of renewable energy credits where fair value measurement is not achieved for all elements of the overall transaction. As there are more and more incentives to facilitate transactions in the renewable energy space, having an ability to address this mismatch may help to expand the activities in this space and help further accelerate the trend.

Historical projects

It is acknowledged that the concept of measuring certain nonfinancial assets at fair value has been considered in the past – for example, as part of the proposed FASB Staff Position (FSP) to amend ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, which would have required that inventories included in an entity's trading activities be initially and subsequently measured at fair value with changes in fair value recognized in earnings – but that such efforts were discontinued after receiving mixed support. However, this proposal addresses many of the concerns raised, including that measurement at fair value not being a requirement in all circumstances. More generally, The Committee observes that many of those that responded were generally supportive of fair value, with the diversity related to the best model or approach to achieve this outcome.

That said, the Committee is sensitive to the concern that elective accounting models provide entities with opportunities for "cherry-picking" P/L recognition and/or booking holdings gains. The Committee suggests that the Board might consider, requiring that the election is made at a portfolio or legal entity level and applied consistently (though the Committee have not seen the aforementioned concerns manifest in practice with regard to the fair value option for *financial* instruments). In fact, it may be that use of a fair value option as a broader policy is most practical for entities regardless, particularly where inventory turnover is meaningful and/or specific identification of a physical commodity is not practical (e.g., the specific molecules of a barrel of oil held in a large tank). As a result, the Committee believes that a fair value option applied at a portfolio or legal entity level would still provide entities sufficient ability to address accounting mismatches that result from its risk management activities.

Finally, in terms of other historical projects and efforts related to this request, it is noted in paragraph A4 of the Basis for Conclusions for FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, highlighted the potential for a "Phase 2" that would consider permitting the fair value option to be elected for certain nonfinancial assets and liabilities. Therefore, the request would seem to align with the original intent of the Board.

Refine hedge accounting if no fair value option

Absent expansion of the fair value option, another alternative would be to amend and simplify fair value hedge accounting for nonfinancial instruments by relaxing effectiveness assessment requirements in exchange for additional disclosures regarding the nature of the hedging activities. For example, if this concept was eliminated in its entirety (i.e., no need to meet a quantitative effectiveness threshold), fair value hedge accounting of nonfinancial assets would function similar to a fair value option, albeit with an ability to de-designate and, therefore, discontinue fair value measurement in part (which may be suboptimal versus an irrevocable election).

While this may be a meaningful leap from the current framework, the Committee observes historically there have been other significant changes to the hedge accounting framework. The elimination of the concept of ineffectiveness for certain cash flow hedges via ASU 2017-12 Targeted Improvements to Accounting for Hedging Activities may be a more extreme notion, as any economic mismatch would be recognized immediately in the context of a fair value hedge, as opposed to being deferred in equity.

Further, for the reasons below, the Committee does not believe these rules would be subject to abuse, such as using derivatives that are unrelated to the arrangements to "hide" speculative activities (e.g., hedge with an equity-linked derivative). One, the fair value measurement of the hedged item and corresponding derivative hedges would be classified within the same line item on the income statement within a hedge accounting framework and, therefore, the effect of risk management strategies would be transparent, with limited ability to mask unwarranted activities from users of the financial statements. Two, disclosure would be required to articulate the nature of risks to which the entity is exposed and the hedging instruments employed; the method(s) used to determine fair value for the arrangements; and the extent of offset that exists in the relationship (i.e., by way of disclosing the changes in fair value observed for the hedged item and hedging instrument).

If necessary, this approach could be supplemented by a requirement to describe the key drivers of mark-to-market movements where there is a significant disconnect observed in the hedging relationship (e.g., an offset that is outside of the 80-125% dollar-offset range generally used to assess effectiveness). This would be another mechanism to provide users transparency, both on the application of hedge accounting as well as their overall risk management activities.

Another alternative would be to explore a benchmark commodity price concept for fair value hedges of non-financial assets for the purpose of the hedge effectiveness assessment. That is, retain the requirement to demonstrate the relationship is highly effective initially and prospectively, but allow such approach to focus on only a portion of the change in fair value of the position. The Committee understands this concept was explored for cash flow hedge accounting as part of the deliberations for ASU 2017-12, but as noted above, The Committee believes the "risk" associated with taking this approach for fair value hedges is notably less given all mark-to-market is recognized currently in earnings and, therefore, any mismatch would be clearly observable and recognized immediately. One potential approach for defining a benchmark concept could be to look at the prices of commodities that are deliverable into exchange-traded futures and forward contracts. Further, to the extent there are multiple contracts that correspond to commodities (e.g., WTI crude v. Brent crude), the entity would need to elect one and apply this consistently. Assuming 2021-004 Comment Letter No. 52 29 the relationship is highly effective, it could also be the case that the commodity is still marked-to-market entirely through earnings (i.e., total changes in fair value), which would reduce the risk of defining a benchmark directly as a function an exchange-traded contract that effectively creates a "perfect" hedge (i.e., one with no accounting mismatch).

Question 54: Beyond financial institutions, are there other entities or industries that hold physical commodities for trading purposes that should be permitted to apply the fair value option to physical commodities? Please explain, including which types of entities or industries and whether and how providing an option would provide decision-useful information.

The Committee supports expanding the FVO to entities beyond financial institutions that hold physical commodities for trading purposes. The option to measure these items at fair value provides a more transparent reflection of economic outcomes and risk management activities than traditional cost-based measures. As noted in the response to Question 53, the lack of a fair value option leads to accounting mismatches where derivatives used to hedge commodity exposures are measured at fair value while the underlying physical commodity or executory contract is not, resulting in volatility in reported earnings that does not reflect economic reality.

While the Committee supports broader use of the FVO, the Committee note that it should remain an irrevocable election made at inception—consistent with the existing FVO model in ASC 825. This provides sufficient control and reduces concerns around earnings management. By permitting FVO for physical commodities, entities are offered a simpler, more direct way to align their accounting with economic hedging strategies without having to apply the hedge accounting model.

The Committee acknowledges that this topic may also be applicable to entities such as asset managers, trading firms, and energy companies that actively manage commodity exposures rather than to traditional manufacturers. However, the Committee sees no conceptual reason to limit access to the FVO and recommend that the Board allow all entities to elect it, provided that proper controls are in place. Broadly permitting the fair value option—applied consistently—would promote comparability, reduce operational costs, and improve financial reporting quality for users.

Closing

The Committee hopes you find ISDA's comments and responses informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter please do not hesitate to contact the undersigned.

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