Ernst & Young LLP
One Manhattan West
New York, NY 10001-8604

Tel: +1 212 773 3000
ey.com

Mr. Jackson M. Day
Technical Director
File Reference No. 2024-ED200
Financial Accounting Standards Board
801 Main Avenue
P.O. Box 5116
Norwalk, CT 06856-5116

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Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements* (File Reference No. 2024-ED200)

Dear Mr. Day:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements* (the proposal), issued by the Financial Accounting Standards Board (FASB or Board). We continue to support the Board's ongoing efforts to improve and simplify its guidance on hedge accounting with an overarching objective to better portray the economic results of an entity's risk management activities in its financial statements.

While Accounting Standards Update (ASU) 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, and other subsequently issued ASUs,[1] significantly reduced the complexity and cost of applying certain aspects of the hedge accounting guidance, stakeholders continue to express concerns about the model. Their concerns include (1) the need for additional clarity on some of the amendments provided in ASU 2017-12, (2) new complexities that have emerged for certain hedging strategies as a result of the global reference rate reform initiative and (3) the lack of decision-useful information provided to financial statement users in reporting the result of missed forecasted transactions for otherwise highly effective cash flow hedging relationships. We believe that the FASB's proposal would address many of these concerns and help to limit the occurrence of dedesignation events and missed forecasts in certain common hedge strategies.

While we are supportive of the FASB's proposal overall, we suggest that the Board reconsider or amend certain aspects related to hedging forecasted interest payments on choose-your-rate debt instruments. In addition, we believe the Board should consider modifying the proposed amendments related to the application of the written option test to further increase its operability for entities seeking to hedge variable-rate loans with interest rate floors using interest rate swaps that contain a similar interest rate floor. These items are discussed further in the Appendix, which provides our responses to the questions for respondents posed in the proposal.

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[1] ASU 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes*, and ASU 2022-01, *Derivatives and Hedging (Topic 815): Fair Value Hedging — Portfolio Layer Method.*

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We would be pleased to discuss our comments with the Board or its staff at their convenience.

Very truly yours,

Ernst & Young LLP

Appendix — Responses to questions raised in the Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815) — Hedge Accounting Improvements*

> Question 1 — Similar Risk Assessment for Cash Flow Hedges: Do the amendments in this proposed Update clarify and improve the guidance on cash flow hedges of individual forecasted transactions hedged as a group? In addition, are the proposed amendments clear and operable? Please explain why or why not. If not, what changes would you suggest?

We agree that the proposed amendments would clarify and improve the guidance on cash flow hedges of individual forecasted transactions hedged as a group and that they would be clear and operable.

We support the Board's proposal to allow entities to hedge a group of forecasted transactions in a single hedging relationship provided that the designated hedging instrument is determined to be highly effective in offsetting changes in the cash flows attributable to each hedged risk in the group, assessed on an individual basis. This is consistent with our belief that if a hedging instrument would be effective at hedging each risk in a group individually, hedge accounting at the aggregate group level should be allowed.

In addition to reducing cost and complexity by aligning the similar risk assessment with the assessment of hedge effectiveness, this approach would enable entities to hedge broader pools of risks in a single cash flow hedging relationship. This could potentially reduce the risk of missed forecasted transactions and would further align the hedge accounting model with the risk management strategies of entities (particularly, financial institutions that hedge pools of variable rate loans).

> Question 2 — Hedging Forecasted Interest Payments on Choose-Your- Rate Debt Instruments: Do the proposed amendments clarify and improve the guidance on cash flow hedges of interest payments on choose-your-rate debt instruments? In addition, are the proposed amendments clear and operable? Please explain why or why not. If not, what changes would you suggest?

We agree that the proposed amendments would clarify and improve the guidance on cash flow hedges of interest payments on choose-your-rate (CYR) debt instruments.

As noted in our 2020 comment letter on Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815): Codification Improvements to Hedge Accounting (File Reference No. 2019-790)*, we were supportive of the Board seeking to develop a broad "change in hedged risk" model as envisioned by ASU 2017-12 that could have been applied across various cash flow hedging strategies. However, we understand the challenges the Board faced in doing so given the existing hedge accounting framework.

Although they would be limited in scope, we support the proposed amendments that would allow certain "change in hedged risk" concepts to be applied to cash flow hedges of interest payments on CYR debt instruments. In addition to addressing diversity in practice, the proposed amendments would simplify the application of hedge accounting for this common strategy, while allowing entities to maintain the flexibility that is fundamental to CYR debt instruments — the ability to change the selected interest rate index or tenor in accordance with the contractual terms of this debt.

In our view, the ability for an entity to continue applying hedge accounting after a change in the selected interest rate index or tenor of its CYR debt, provided that the hedge remains highly effective, more closely aligns the hedge accounting model with the entity's risk management objectives.

Further, Scenario B in Example 28 of the proposal[2] makes it clear that even if the hedging instrument is not deemed to be highly effective at offsetting the cash flows from the revised index or tenor in the CYR debt, the entity would not have to reclassify the previously recognized gains or losses on the derivative from accumulated other comprehensive income (AOCI) to earnings, despite having to cease applying hedge accounting. That is, this would not result in a missed forecast, and the entity would reclassify the frozen balance in AOCI to earnings as the forecasted interest payments from the existing CYR debt (or replacement debt) affect earnings (unless it becomes probable that the forecasted transaction will not occur). We believe this outcome would represent better financial reporting and provide more decision-useful information about the entity's risk management strategy.

In addition, while we believe that the proposed amendments generally would be clear and operable, there are certain aspects of the proposed guidance on hedging CYR debt that we suggest the Board reconsider or amend, as discussed below.

Maturity date requirement

As a condition for applying the proposed guidance on hedging CYR debt, proposed paragraph 815-30-35-37C(b) would require that the maturity date of the existing CYR debt be on or after the end of the hedge period. In addition, while none of the scenarios in Example 28 of the proposal explicitly address a situation where the maturity date of the replacement debt is before the end of the hedge period, paragraph BC36 in the Background Information and Basis for Conclusions of the proposal states that "the replacement debt instrument must mature on or after the last interest payment hedged under the original choose-your-rate debt instrument."

Based on these requirements, it appears that an entity that replaces its existing CYR debt with CYR debt maturing before the end of the hedged period would be required to dedesignate its existing hedging relationship and immediately reclassify amounts previously recognized in AOCI into earnings, even if it is probable that upon the maturity of this replacement debt, the entity will enter into new CYR debt whose maturity extends to or beyond the end of the hedged period. In our view, accounting for such a situation as a missed forecast seems inconsistent with the Board's objective to better align financial reporting with entities' risk management strategies by reducing dedesignation events and missed forecasts for otherwise highly effective hedging relationships.

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[2] ASC 815-30-55-174 through 55-175.

In addition, based on the existing illustrative example in ASC 815-20-55-106 through 55-110, if a similar situation occurred, but the entity was hedging forecasted interest payments indexed to a single contractually stipulated interest rate (e.g., one-month term SOFR), we believe hedge accounting could continue, as long as it remains probable that the entity will be exposed to variability in one-month term SOFR based on an amount of debt principal equal to or greater than the notional amount of the swap during the remaining term of the interest rate swap.[3]

Taking into consideration the above, we suggest that the Board reconsider whether to keep the maturity date requirement in any final guidance issued.

Forecasted issuance of CYR debt

The proposed amendments in ASC 815-30-35-37C make it clear that the proposed guidance on hedging CYR debt would apply only to existing CYR debt and cannot be applied by analogy to the forecasted issuance of debt not considered replacement debt as described in paragraph 815-30-35-37D. Therefore, if an entity designates a hedge of interest rate risk related to its expected issuance of CYR debt at some point in the future, the proposed guidance on hedging CYR debt could not be applied to this hedging relationship.

Upon the issuance of the CYR debt in the future, an entity that wants to avail itself of the benefits of the CYR debt guidance would need to dedesignate its original hedge relationship and redesignate a new hedging relationship of the now existing CYR debt using its existing derivative, which would likely be off-market (i.e., the derivative would have a non-zero fair value).

If the new hedging relationship using the off-market hedging instrument is highly effective, the accounting outcome would be consistent with allowing the application of the proposed guidance to the forecasted issuance of CYR debt at the inception of the hedging instrument. However, if the off-market nature of the hedging instrument results in the new hedging relationship not being deemed highly effective, the entity would likely need to enter into a new at-market hedging instrument in order to apply hedge accounting, with the original hedging instrument either being settled or marked to market through earnings.

If an entity chose not to dedesignate and redesignate the hedging relationship upon the issuance of the CYR debt, it could continue to apply hedge accounting but would be precluded from applying the proposed guidance on hedging CYR debt. This would result in the entity effectively having to give up the flexibility to change the index or tenor of its CYR debt or potentially recognize a missed forecast if it subsequently elected to change the interest rate index or tenor from the one initially designated as being hedged.

Given these outcomes, we suggest the Board reconsider whether the guidance on hedging CYR debt can be applied to the forecasted issuance of CYR debt in any final guidance issued.

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[3] ASC 815-20-55-109 states that "[t]he prepayment of the original variable-rate debt eliminates the contractual obligation to make those interest payments; however, this Subtopic permits replacing the hedged interest payments that are no longer contractually obligated to be paid without triggering the dedesignation of the original cash flow hedging relationship. Replacing the original debt issuance with a new variable-rate debt issuance is permissible in a cash flow hedge of interest rate risk and does not automatically result in the discontinuation of the original cash flow hedging relationship."

Example 9: Changes in a Cash Flow Hedge of Forecasted Interest Payments with an Interest Rate Swap

We note that the proposal would include certain conforming amendments to Example 9 in ASC 815-30-55-52 through 55-61 to remove references to the London Interbank Offered Rate (LIBOR). We agree with maintaining this example in the guidance but suggest changing the description in ASC 815-30-55-54 of the instruments initially expected to be issued in the five-year borrowing program from fixed-rate 90-day notes to 90-day notes based on three-month term SOFR and the description of the hedging instrument from an interest rate swap whose variable leg is based on 90-day average SOFR in arrears to one where the variable leg is based on three-month term SOFR.

This would also require changing the description in ASC 815-30-55-60 of the new three-year variable rate note issued from one based on three-month term SOFR to one based on 90-day average SOFR in arrears.

We believe these changes would be more consistent with the example as originally drafted and avoid any potential complications stemming from designating a benchmark interest rate as the hedged risk in the example.

Question 3 — Cash Flow Hedges of Nonfinancial Forecasted Transactions: Do the proposed amendments clarify and improve the guidance on cash flow hedges of nonfinancial forecasted transactions? In addition, are the proposed amendments, including those that require the application of the clearly-and-closely-related assessment, clear and operable? Please explain why or why not. If not, what changes would you suggest?

We agree that the proposed amendments would clarify and improve the guidance on cash flow hedges of nonfinancial forecasted transactions and that they would be clear and operable.

We support expanding the components eligible to be designated as the hedged risk in the forecasted purchase or sale of a nonfinancial asset by allowing entities to designate variable price components of the forecasted purchase or sale that are considered clearly and closely related to the nonfinancial asset in accordance with the normal purchases and normal sales scope exception guidance in ASC 815. Enabling entities to hedge components beyond those that are contractually specified in a pricing formula of a contract would simplify the application of hedge accounting for certain hedge strategies, clarify that eligible components can be hedged in spot market transactions and further align hedge accounting requirements with an entity's risk management activities.

In addition, we believe that the proposed example in paragraphs 815-30-55-160 through 55-164 (Example 27) would be very useful in illustrating how the proposed guidance on nonfinancial component hedging would be applied to not-yet-existing contracts. This example also serves to highlight that the proposed guidance related to hedging a group of forecasted transactions with similar risks (addressed in Issue 1) can be applied to hedges of nonfinancial risk, as well as financial risk.

Finally, we support clarifying that an entity may designate a variable price component as the hedged risk in a contract to purchase or sell a nonfinancial asset accounted for as a derivative, provided that the associated forecasted purchase or sale of the nonfinancial asset qualifies to be a hedged forecasted transaction (e.g., the forecasted transaction is probable of occurring).

As noted in our previous comment letters from 2016 and 2020 on proposed hedge accounting improvements, we believe it is overly restrictive and inconsistent with entities' risk management strategies to limit the ability to hedge a variable price component in these situations to when an entity has elected the normal purchases or normal sales scope exception for the derivative (as currently required in 815-20-25-22A(a)) or when physical settlement of the derivative contract is deemed probable (as proposed in the Board's 2019 exposure draft on Codification improvements to hedge accounting). We note that the risk an entity is exposed to and is attempting to hedge (i.e., variability in the purchase or sales price of the nonfinancial asset) does not change, regardless of whether the physical purchase or sale stems from a contract accounted for as a derivative.

Question 4 — Net Written Options as Hedging Instruments: Do the proposed amendments improve the guidance on net written options as hedging instruments? Please explain why or why not. If not, what changes would you suggest? In addition, the Board rejected an alternative to the proposed amendments related to the net written option test in paragraph 815-20-25-88 that would have removed the test from Topic 815 (see paragraph BC81). Do you have any views on the alternative rejected by the Board and whether it would be more operable, be less complex, and provide more decision-useful information compared with the proposed amendments?

We agree that the proposed amendments would improve the guidance on the use of net written options as hedging instruments for cash flow hedges of interest rate risk where the hedging instrument is a combination of a written option and any other non-option derivative instrument.

The proposed amendments to allow entities to make certain simplifying assumptions when performing the written option test would improve the operability of this test in a post-LIBOR environment where mismatches between the underlyings in the hedged item and hedging instrument have become more common.

An example of a mismatch would be when the variable leg of the interest rate swap designated as the hedging instrument is based on daily SOFR, but the variable-rate loan being hedged is tied to term SOFR. In this case, if a floor was included in the swap, the entire hedging instrument would be considered a written option under the guidance in ASC 815-20-25-88. This instrument would likely not pass the written option test, even if a floor with the same strike were included in the loan given the difference in underlyings (i.e., a floor based on daily SOFR may be in the money when a floor based on term SOFR is not, or vice versa). When hedging a portfolio of variable loans, differences in payment and reset dates between the hedging instrument and the various loans in the portfolio also make it challenging to apply the written option test.

While we agree that the proposal would improve the operability of the written option test, we believe that the benefit would generally be limited to hedges of loans with interest payments that settle and/or reset at least monthly and would be less applicable to common hedge strategies where the coupon payments on the swaps and loans settle and/or reset quarterly or semiannually. Therefore, we suggest that the Board consider amending the scope of the simplifying assumptions in any final guidance to allow entities to assume the payment and reset dates of the hedging instrument and hedged forecasted

transactions match when they occur within the same 181-day period (or even in the same fiscal year to cover hedges of variable loans with interest payments that settle and/or reset annually).[4]

If the Board decides to reconsider its decision on eliminating the written option test, we suggest it consider whether standalone written (or net written) options should be eligible to be designated as hedging instruments.

Standalone written (or net written) options are generally seen as instruments that expose an entity to risk because the writer takes on the potential for significant losses while the maximum gain potential is limited to the premium received, which is realized if the option expires worthless. Therefore, their usefulness as instruments that serve to mitigate risk is questionable. This concern was highlighted in paragraph 396 of the Background Information and Basis for Conclusions of Statement of Financial Accounting Standard (SFAS) No. 133, which states "[t]he Board is concerned about permitting written options to be designated as hedging instruments because a written option serves only to reduce the potential for gain in the hedged item or hedged transaction. It leaves the potential for loss on the hedged item or hedged transaction unchanged except for the amount of premium received on the written option. Consequently, on a net basis, an entity may be worse off as a result of trying to hedge with a written option."

While the Board ultimately decided not to preclude the use of all written options as hedging instruments, it included the written option test to guard against entities receiving favorable hedge accounting treatment for strategies intended to sell a portion of an asset's or liability's gain potential, including covered call strategies or the collar strategy described in paragraph 400 of the Background Information and Basis for Conclusions of SFAS No. 133. If the Board chooses to eliminate the written option test without providing any restrictions on the use of standalone written (or net written) options as hedging instruments, such strategies may qualify for hedge accounting as entities have flexibility in how they define their risk management strategies.

The concern regarding hedging with written options is generally less significant when the hedging instrument is a derivative that results from combining a written option and another non-option derivative (e.g., an interest swap that includes a written floor on the variable leg), particularly when the hedged item includes a purchased option. Given the cash flows associated with the non-option component of these instruments, they can often serve to mitigate risk. Eliminating the written option test would simplify the application of hedge accounting for these instruments and broaden the strategies where they can be used as hedging instruments.[5]

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[4] It is worth noting that unlike the existing guidance in 815-20-25-84A related to hedging a group of forecasted transactions that allows entities to assume that the timing of when the hedged transactions are expected to occur and the maturity date of the hedging instrument match if they occur within the same 31-day period or fiscal month for purposes of applying the critical terms match method (as the hedge effectiveness assessment), the simplifying assumptions in this proposal would only apply in the performance of the written option test to determine if the instrument is an eligible hedging instrument. Any actual differences between the hedging instrument and hedged item would need to be considered when assessing hedge effectiveness.

[5] Alternatively, the Board could choose to retain the written option test but remove the guidance in ASC 815-20-25-8 stating that "a derivative instrument that results from combining a written option and any other non-option derivative instrument shall be considered a written option." This would result in the written option test being applied solely to standalone written (or net written) options.

For example, an entity could use an interest swap that includes a written floor to hedge interest rate risk within specified parameters of a variable rate asset that does not include a floor if the swap is deemed to be highly effective at offsetting the designated hedge risk. In evaluating this approach, the Board should make sure it is comfortable with the various potential strategies that entities may employ.

Question 5 — Foreign-Currency-Denominated Debt Instrument as Hedging Instrument and Hedged Item (Dual Hedge): Do the proposed amendments improve the guidance on a foreign-currency-denominated debt instrument that is used as the hedging instrument and hedged item (commonly referred to as a "dual hedge")? In addition, are the proposed amendments on dual hedges clear and operable? Please explain why or why not. If not, what changes would you suggest?

We agree that the proposed amendments would improve the guidance related to a foreign-currency-denominated debt instrument being used as the hedging instrument in a net investment hedge and the hedged item in a fair value hedge of interest rate (i.e., a dual hedge) and they would be clear and operable.

We believe the proposal to require entities to immediately recognize the gains and losses from the remeasurement of the foreign-currency-denominated debt instrument's fair value basis adjustment in earnings in accordance with ASC 830-20 better reflects the economics of the dual hedge relationship and further aligns the hedge accounting model with the risk management objectives of the entities that apply this strategy.

Question 6 — Transition: Are the proposed transition requirements operable? If not, why not, and what transition method would be more appropriate and why? Would the proposed transition disclosures be decision useful? Please explain why or why not.

We believe the proposed transition requirements would be operable and support prospective application.

Additionally, we support the additional guidance in paragraph 815-20-65-7 to help facilitate the transition for existing hedges. This guidance would help entities apply the proposed improvements to existing hedges upon adoption without having to dedesignate and redesignate these hedges. This would result in greater consistency in the accounting for existing hedges and similar hedges executed after adoption.

Question 7 — Effective Date: In evaluating the effective date, how much time would be needed to implement the proposed amendments? Should the effective date for entities other than public business entities be different from the effective date for public business entities? Please explain why or why not. If the effective dates should be different, how much additional time would entities other than public business entities need to implement the proposed amendments?

We observe that the proposal would generally simplify the existing hedge accounting requirements, and therefore, entities would not be expected to develop new or additional processes and controls, with the possible exception of entities applying the amendments to hedge components of forecasted nonfinancial transactions.

However, we defer to preparers about how much time would be needed to implement the proposed amendments. We recommend that the Board determine the effective dates based on feedback from these constituents.

Question 8 — General: Do you expect any unintended consequences of providing these proposed amendments? If so, please explain what those unintended consequences would be.

Because the targeted improvements would be fairly narrow and generally simplify existing requirements, we do not expect any significant unintended consequences.

Question 9 — Benefits and Costs: Would the expected benefits of the proposed amendments justify the expected costs? If not, please describe the nature and magnitude of those costs, differentiating between one-time costs and recurring costs.

Given that the proposed amendments would generally serve to simplify the existing hedge accounting requirements, we believe the expected benefits justify the costs. However, we believe investors and preparers are better positioned to answer this question.