ISDA® Safe, Efficient Markets

March 30, 2018

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06855-5116
By e-mail: director@fasb.org

Re: File Reference Number 2018-220, Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815) – Inclusion of the Overnight Index Swap (OIS) Rate Based on the Secured Overnight Financing Rate (SOFR) as a Benchmark Interest Rate for Hedge Accounting Purposes*

Dear Ms. Cosper,

The International Swaps and Derivatives Association's ("ISDA")[1] North America Accounting Committee (the "Committee") appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB" or the "Board") Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815) – Inclusion of the Overnight Index Swap (OIS) Rate Based on the Secured Overnight Financing Rate (SOFR) as a Benchmark Interest Rate for Hedge Accounting Purposes* (the "Exposure Draft"). Collectively, the Committee members have professional expertise and practical experience addressing accounting policy issues related to financial instruments and specifically derivative

[1] Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. Today, ISDA has over 875 member institutions from 68 countries. These members comprise of 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. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework. Information about ISDA and its activities is available on the Associations web site: www.isda.org.

financial instruments. This letter provides our organization's overall views on the Exposure Draft and our responses to the questions for respondents included within the Exposure Draft.

Key messages

The Committee supports the Board's actions to add the Secured Overnight Funding Rate ("SOFR") as an eligible U.S. benchmark interest rate for hedge accounting purposes under Topic 815. Our members, as active market participants, acknowledge the importance of replacing LIBOR and are eager to facilitate and encourage a smooth market transition away from LIBOR to the replacement rate selected by the Federal Reserve Board's Alternative Reference Rate Committee ("ARRC") in line with the goals of the Financial Stability Oversight Council and the Financial Stability Board.

However, given that the Overnight Index Swap ("OIS") rate is based on daily observations of SOFR (an overnight borrowing rate), we believe the benchmark rate that the Board should consider adding is a broad-based SOFR swap rate, similar to the LIBOR swap rate, which would cover various tenors, including an overnight rate.

A broad-based SOFR swap rate would provide the market greater flexibility for developing longer interest rate tenors referencing SOFR without the need for the Board to add another benchmark interest rate to the Accounting Standards Codification or modify the SOFR OIS Rate definition to include longer tenors.

Separately, certain accounting transition relief may be needed to ensure a smooth shift to a SOFR-based market. As discussed in our responses to the Questions for Respondents posed in the Exposure Draft, we believe additional steps will need to be taken in order to further facilitate the markets acceptance, and broader use of SOFR.

Responses to FASB's Questions for Respondents

Question 1: *The Board decided to propose that the OIS rate based on SOFR should be added as a U.S. benchmark interest rate. Should the OIS rate based on SOFR be included as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815? Why or why not?*

As described in our overall remarks, the Committee is supportive of adding SOFR to the list of acceptable benchmark rates but believes that a broad-based SOFR swap rate should be added. Please see our response to Question 2 below for our views in support of a broad-based SOFR swap rate.

However, the Committee is supportive of adding a SOFR OIS rate to the extent the Board is not prepared to add a broad-based SOFR swap rate. The Committee would not want to impede the Board's progress on this Exposure Draft.

Question 2: *The Board's proposal to add the OIS rate based on SOFR rather than a broader SOFR swap rate that would be the equivalent of the LIBOR swap rate is based on the ARRC's paced transition plan which indicates that OIS swaps referencing SOFR are expected to begin trading in 2018. Over a longer term horizon swaps referencing a SOFR term rate (that is tenors greater than overnight) may be developed in the marketplace. Should a broader SOFR swap rate be included as a U.S. benchmark interest rate instead of the OIS rate based on SOFR?*

The Committee supports the actions taken by the Board that further contribute to the market's acceptance of SOFR. Our members agree with the Board that SOFR should be added to the list of acceptable benchmark rates under Topic 815 for the following reasons:

- The Master Glossary defines the term *benchmark interest rate* as "*a widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions. In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate*." As discussed by the Board in BC14, SOFR would meet the Master Glossary Definition of a benchmark interest rate as the rates underlying SOFR are the financing rates on overnight repurchase transactions that are secured by U.S. Treasury securities as collateral. Furthermore, these underlying transactions are considered close to risk-free and are widely quoted and recognized.
- The Committee notes that when the OIS rate based on the Fed Funds Effective Rate was added in 2013, the OIS swap market was not widely traded. As noted by the FASB in BC16, since the OIS rate based on the Fed Funds Effective Rate was added in 2013, available data indicates that there has been an increase in the volume of OIS swaps based on the Fed Funds Effective Rate. Therefore, it is reasonable to assume that similar activity will occur for swaps with rates based on SOFR.
- Adding SOFR as a benchmark interest rate will facilitate the market's acceptance of SOFR as an interest rate to be used in hedging activities and align such hedging activities with risk management strategies as SOFR becomes a widely used rate across financial products.
- Under IFRS 9, *Financial Instruments*¸ it is expected that SOFR will qualify as a component that may be hedged as it is both separately identifiable and reliably measurable. Allowing SOFR to be a benchmark interest rate under Topic 815 will allow consistent hedge accounting application between U.S. GAAP and IFRS.

Although the Board is currently proposing to add an OIS rate based on SOFR as a benchmark interest rate, the Committee believes the Board should consider adding a broad-based SOFR swap rate rather than the narrow OIS rate based on SOFR.

A broad-based SOFR swap rate, which would be inclusive of an overnight rate, would allow the market greater flexibility to replace the U.S. Dollar LIBOR swap rate that is currently quoted with different tenors. Further, the ARRC transition plan notes that there would be a term structure developed for cash instruments over time, and thus, it is reasonable to expect that SOFR swaps will also develop as the cash instrument market evolves. While the specific methodology that will be used to develop a term structure is still to be determined, we understand that a binding constraint identified by the ARRC is that the forthcoming term reference rate must be compliant with the International Organization of Securities Commissions' (IOSCO) Principles of Financial Benchmarks. Broadly, these principles are intended to promote the reliability of benchmark determinations, and address the governance, quality and accountability thereof.

While the FASB has acknowledged this expected timeline in BC17, the Committee encourages the Board to reduce any uncertainty now by adding the broad-based SOFR swap rate. Adding a broad-based SOFR swap rate would reduce any market uncertainty about the potential need for future standard setting and the administrative burden of the Board having to perform standard setting in the future.

The Committee would propose the following edits to the Master Glossary language currently present in the Exposure Draft:

> **Secured Overnight Financing Rate (SOFR) ~~Overnight Index~~ Swap Rate**
>
> The fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Secured Overnight Financing Rate (SOFR) ~~(an overnight rate or)~~ <u>or to a term reference rate based on SOFR-derivative markets</u> with no additional spread ~~over SOFR~~ on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the variable cash flows.

Using the Committee's proposed language above, upon different tenors being quoted for swaps, the rates would immediately meet the definition of the SOFR Swap Rate and thus be an eligible benchmark rate for hedging purposes. Our members believe that the Board can explain further that a Swap Rate, as defined above, covers multiple tenors, including an overnight rate, as is practice for the LIBOR swap rate today.

Question 3: *For hedging relationships of benchmark interest rate risk for which the designated hedged risk will be changes in fair values or cash flows attributable to changes in the OIS rate based on SOFR should the Board consider providing any transition relief upon designation of SOFR as a benchmark rate? If so please describe the specific types of relief needed and whether relief is necessary for existing hedging relationships based on LIBOR that will transition to SOFR or newly designated hedging relationships based on SOFR.*

Based on the Committee's understanding of certain transition steps being taken by current market participants, including ISDA of which this Committee is a part of, certain relief guidance would be needed to ensure that the transition from LIBOR to SOFR would not hamper market participants' migration and cause any unintended consequences.

In order to avoid the need for bilateral counterparty negotiations to amend LIBOR-indexed derivative contracts, the industry is currently working to develop fall-back protocol[2] language that, once agreed to, could be incorporated "by reference" to all currently executed contracts. This language is intended to provide a universal mechanism to help facilitate the transition from LIBOR-indexed contracts. Further, in order to ensure that no value is transferred between counterparties, the fixed leg may need to remain the same while the variable leg will become SOFR plus a market spread to LIBOR as determined at the transition date.

The Committee believes that in order to prevent substantial hedge dedesignations for existing fair value hedges, transition guidance would be needed for the following:

1. The addition of SOFR fall-back protocol language in the swap agreement, and the triggering of the fall-back protocol or a voluntary change absent the inclusion of fall-back protocol language, in an existing hedge relationship would not be deemed a change in the critical terms of the hedging instrument (i.e., would not cause a dedesignation event); and
2. To allow the benchmark interest rate for existing fair value hedges to change to SOFR and allow for the measurement of the benchmark component interest cash flows of the hedged item to be adjusted based on the new SOFR rate without requiring dedesignation. The Committee expects that market participants will choose a transition method that will avoid any fair value changes to derivatives at transition (such as by adding a spread to the variable legs of swaps to account for any SOFR-LIBOR basis difference at that date). Therefore, the Committee believes a similar result may be appropriate for the hedge basis adjustment for the hedged item. To avoid an immediate change in the hedge basis adjustment upon transition, the benchmark component interest cash flows could be reset at transition to an amount that maintains the current basis adjustment but now reflects that they

[2] https://www.isda.org/2017/11/28/development-fallbacks-libor-key-ibors-faqs/

will be remeasured by SOFR rather than LIBOR. Similar transition relief may be needed for cash flow hedges of forecasted issuance of debt.

The Committee believes that it was the intent of the Exposure Draft to mostly focus on fair value hedges of benchmark interest rates. Separate from this Exposure Draft, the Committee would welcome the opportunity to provide further input on other cash flow hedging transition issues when the Board is prepared to consider them further.

Question 4*: Should additional disclosures be required? If yes please explain what specific additional disclosures should be required and why.*

It is the Committee's belief that existing disclosure requirements are sufficient to explain any change in risk management objectives. However, we would be supportive of the Board suggesting that entities discuss when they have transitioned to SOFR in current disclosures for an entity's risk management objectives.

We note that this is consistent with the Board's decision in ASU 2013-10, *Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes*. As noted in the Basis for Conclusions of ASU 2013-10, "Topic 815 requires extensive quantitative and qualitative disclosures about derivatives and hedging activities primarily based on underlying risk and accounting designation; however, it does not require that an entity specifically disclose the actual interest rate benchmark (for example, UST or LIBOR) that is hedged. The Task Force concluded that it is not necessary to revisit the Board's previous conclusions as to the granularity of disclosures about derivatives and hedging activities."

Question 5*: Should the proposed amendments be applied on a prospective basis only for qualifying new or redesignated hedging relationships? If not please explain why.*

Consistent with our response to Question 3 above, the Committee believes that the proposed amendments should not just be applied on a prospective basis for qualifying new or redesignated hedges but also to existing hedging relationships. Due to the prevalence of LIBOR-indexed swaps currently, all current hedging relationships with periods that overlap with or go well beyond the ARRC's transition timeline will be impacted and may require transition guidance as discussed above.

Question 6*: Should the effective date of the proposed amendments coincide with the effective date of Update 2017-12? If not, when should the proposed amendments be effective? Please explain why.*

Our members agree that the effective date of the proposed amendments should coincide with the effective date of Update 2017-12. Any transition guidance provided as part of the amendments should be allowed by entities to adopt on a hedge-by-hedge basis. If aligned with Update 2017-12, we would encourage the Board to allow for early adoption in any interim period after the issuance of this Update regardless of an entity's election to early adopt Update 2017-12.

Closing

We hope you find the ISDA Accounting Committee'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 Matt Esposito at (212) 816 - 5371.

Matthew Esposito
Citigroup Inc
Chair, North America Accounting Committee

Antonio Corbi
ISDA, Inc
Director, Risk and Capital