ISDA® Safe, Efficient Markets

November 13, 2020

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

By email: director@fasb.org

Re: File Reference No. 2020-900, Exposure Draft, *Reference Rate Reform (Topic 848)*

Dear Ms. Salo,

The International Swaps and Derivatives Association's (ISDA)[1] Accounting Policy Committee appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB) Exposure Draft, *Reference Rate Reform (Topic 848): Scope Refinement* (the Exposure Draft). Collectively, the Committee members have substantial professional and practical expertise addressing accounting policy issues related to 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.

Overview

ISDA supports the FASB's proposals in the Exposure Draft to refine the scope of Topic 848 in order to address the accounting implications of the discounting transition for derivative contracts that do not reference a rate that is expected to be discontinued (as required by the scope of Topic 848). We believe the Exposure Draft achieves the FASB's objective of refining the scope of Topic 848 such that contracts affected by the discounting transition would be eligible for certain optional expedients and exceptions in Topic 848.

The following are the Committee's responses to the FASB's questions which include additional comments and proposed refinements for the FASB's consideration.

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 925 member institutions from 75 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 Twitter, LinkedIn, Facebook and YouTube.

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Responses to FASB's Questions for Respondents

Question 1—Scope Refinement: Do you agree that the scope of Topic 848 should be refined to include contracts that do not reference a rate expected to be discontinued as a result of reference rate reform but that are affected by the discounting transition? Why or why not?

Yes, we agree that Topic 848 should be refined to include contracts that do not reference a rate expected to be discontinued as a result of reference rate reform but that are affected by the discounting transition. The Committee believes that this scope refinement will avoid diversity in practice with respect to the discounting transition for contracts that do not reference a rate expected to be discontinued.

The Committee notes that while centrally-cleared derivatives (particularly those denominated in major currencies such as the U.S. Dollar and the Euro, among others) have migrated from discounting and margin/price alignment based on the interest rates underpinning legacy overnight indexed swaps (e.g., Effective Federal Funds Rate for U.S. Dollar interest rate swaps) to new replacement rates (e.g., SOFR), uncleared over-the-counter (OTC) derivatives that are subject to credit support agreements (CSAs) may migrate their discounting and interest earned on cash collateral to new reference rates over a longer-term horizon.

In addition, for certain uncleared bilateral derivative contracts, we expect that the discounting transition may extend beyond the sunset date of Topic 848 given the requirement for bilateral negotiations and differing timelines of when other interbank offered rates will be discontinued.

Therefore, we believe the FASB should make clear in the Basis for Conclusions that this relief guidance was issued to accomplish two objectives: (1) to prevent potential diversity in practice and (2) to clarify that a change in the market interest rate used to discount cash flows associated with derivative contracts is not a change in a critical term that would require dedesignation.

In addition, for the avoidance of doubt, the FASB should also clarify in Topic 815 that a change in the market interest rate used to discount cash flows associated with derivative contracts is not a change in a critical term that would require dedesignation. This would be consistent with historical practice, including the change in the discounting rate for the collateral of certain derivative contracts after the financial crisis from LIBOR to the Effective Federal Funds Rate, which was not a change in critical terms that required de-designation. This change to Topic 815 will ensure that this component is not subject to the sunset provisions of Topic 848.

For these reasons, the Committee believes adding such a clarification within the Basis for Conclusions and in the Codification will prevent diversity in practice for future changes in the rate used for discounting derivative contracts without the need for additional standard setting.

Question 2—Operability: The Board is proposing amendments in this Update to the expedients and exceptions in Topic 848 to capture the incremental consequences of the proposed scope refinement and tailor the existing guidance to derivative instruments affected by the discounting transition. Are those proposed amendments complete and operable? If not, what suggestions do you have and why?

Yes, we believe the proposed amendments are broadly complete and operable.

As noted above, the Proposed Update will be reflected as part of Topic 848, which has a sunset date of December 31, 2022.

Per the Alternative Reference Rate Committee's Recommend Best Practices[2], the transition of the interest rates used for discounting and margining uncleared collateralized OTC derivatives for CSAs between swap dealers is generally expected to occur in phases, with the initial phase expected to begin by the end of 2020. However, the timing of the transition of interest rates used for discounting and margining of other uncleared OTC derivatives remains unclear and may occur over the course of years (and potentially after December 2022) due to the time required for major derivative dealers to bilaterally re-negotiate their CSAs with clients and varying transition timelines across legacy IBORs, which must be completed in the face of other competing priorities affecting these stakeholders.

In light of the above, we recommend that the FASB explicitly exempt the relief included in the Proposed Update from the sunset provisions of Topic 848 and instead codify in Topic 815 that changes to derivative contracts related to derivative discounting and margining do not meet the definition of a change in critical terms whether in connection with the market's broader transition away from IBORs or otherwise.

Question 3—Effective Date and Transition: Do you agree with the proposed effective date and transition guidance? Why or why not?

Yes, we agree with the proposed effective date and transition guidance. Given that the multiple discounting transitions have already occurred, including the discounting transition for cleared U.S. dollar-denominated interest rate swaps in October 2020, the Committee believes the Proposed Update should be effective immediately upon issuance.

Further, we believe the option for retrospective or prospective application will give entities needed flexibility in transition.

Question 4—Ongoing Monitoring: Are there other accounting consequences related to reference rate reform that the Board should consider?

The Committee believes there are other accounting consequences related to reference rate reform that the Board should consider. While we believe these are important issues that the Board should address as part of reference rate reform, we do not believe the Board should delay final issuance of the Proposed Update in order to address these issues.

1) Portfolio Hedging

One of the fundamental differences between LIBOR and many alternative reference rates (ARRs) such as SOFR is that LIBOR is a term rate while ARRs are overnight rates for which no term rates are currently available. As a result, many ARR-based cash products will likely use a convention of averaging daily rates in-arrears to approximate a term rate (e.g., compound average in-arrears or simple average in-arrears).

In today's LIBOR environment, entities may have portfolio hedges that include various tenors of

[2] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Best-Practices.pdf Refer to Recommendation 2 under "E Derivatives"

LIBOR (e.g. a 1-month LIBOR pool and a 3-month LIBOR pool) that they hedge on a "first-payments received" basis. For these hedging relationships, entities are hedging a type of cash flow rather than cash flows from a specific instrument.

As firms begin to transition to SOFR, or issue new SOFR loans, several practice questions will arise for those who have multiple portfolio hedges for various tenors of LIBOR.

Topic 848 (and specifically ASC 848-50-25-14) allows an entity to disregard the guidance in ASC 815-20-25-15(a)(2), which states that a group of individual transactions shall share the same risk exposure for which they are being hedged.

It is not clear how different tenors of LIBOR rates will be transitioned to new reference rates that do not rely on term rates, and therefore we recommend that the FASB allow entities to use reasonable methods to replace items in the hedged portfolios. For example, items that reference SOFR but are subject to a one-month or three-month average rate could be included in hedged pools that currently reference one-month or three-month LIBOR rates, respectively.

2) Net investment hedging with a float-to-float cross currency swap

It is clear that the scope of Topic 848 includes derivatives that are designated as net investment hedges of foreign operations if they are affected or are expected to be affected by reference rate reform. However, we believe clarification is needed with respect to the application of the relief. Specifically, ASC 815-20-25-67 allows entities to designate a receive-variable, pay-variable cross-currency derivative as a hedge of a net investment in a foreign operation if certain conditions are met:

Hedging instruments that are eligible for designation in a net investment hedge include, among others, both of the following:

a. A receive-variable-rate, pay-variable-rate cross-currency interest rate swap, provided both of the following conditions are met:

   1. The interest rates are based on the same currencies contained in the swap.
   2. Both legs of the swap have the same repricing intervals and dates.

We note that under reference rate reform, the transition timing may not be the same for the legacy variable rates underlying each leg of the swap. For example, SOFR may replace the USD LIBOR rate in the USD leg of the swap before the legacy LIBOR rate associated with the foreign currency leg is replaced. It is expected that the market convention will replace a legacy term rate (i.e., 3-month USD LIBOR) with an overnight rate that is compounded in arrears for the same period (i.e., overnight SOFR rates compounded for 3 months).

We believe it is clear this should be seen as the equivalent of a 3-month rate, as it is the compounded rate that is the basis for calculating the periodic net settlement for the derivative. However, there appears to be a lack of clear consensus regarding whether both legs of the swap continue to have the same repricing intervals, as required under ASC 815-20-25-67(a)(2). This is because although the rate "resets" every three months (i.e., averaging based on a specific compounding period), there is an overnight "resetting" of the rate being compounded.

It is expected that this situation will be resolved when both legs transition and reference an overnight rate, but until that time, it would be helpful for the Board to clarify that relief is available for these hedges to avoid de-designation during the respective transitions of the underlying reference rates.

Closing

We hope 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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