

April 19, 2013

Ms. Susan M. Cospers  
Director of Technical Application and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**Re: File Reference Number EITF 13A, Exposure Draft, *Derivatives & 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***

Dear Ms. Cospers,

The International Swaps and Derivatives Association's (ISDA) Accounting Policy Committee<sup>1</sup> appreciates the opportunity to provide comments and responses on the Financial Accounting Standards Board's ("FASB") Exposure Draft, *Derivatives & 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* (the "Exposure Draft"). This letter (i) provides our organization's overall views on the Exposure Draft and (ii) addresses the questions for respondents included within the Exposure Draft.

**Key messages:**

The Fed Funds Effective Rate<sup>2</sup> has emerged as a prevalent, widely-used market interest rate. As the collateralization of financial exposures and movement to centrally cleared over-the-counter derivatives has dramatically expanded, the need to manage exposure to the Fed Funds Effective Rate has increased significantly. Accordingly, we are supportive of the proposed guidance to include the Fed Funds Effective Swap Rate as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815.

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<sup>1</sup> ISDA's Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.

<sup>2</sup> The terms "Fed Funds Effective Rate" and "Fed Funds" may be used interchangeably and encompasses the Fed Funds Effective Swap Rate.

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As risk management objectives change in response to developments in the financial markets, we believe the “benchmark” definition must also evolve. The opportunity to designate changes in fair value or cash flows attributable to changes in the Fed Funds Effective Swap Rate will allow companies to better reflect their current risk management activities in their financial statements.

However, our members have raised concerns regarding whether reconciliation is needed between the requirements in paragraph 815-20-25-6 with the proposed guidance in the Exposure Draft. Paragraph 815-20-25-6 includes the following guidance:

...Ordinarily, an entity shall designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraphs 815-20-25-80 through 25-81. The use of different benchmark interest rates for similar hedges shall be rare and shall be justified....

These concerns result not on transition where a current hedging relationship includes LIBOR as a benchmark interest rate and a newly designated hedging relationship includes the Fed Funds Effective Swap Rate, but instead when evaluating all interest rate hedging relationships that are new or redesignated after the issuance date of the final Update.

ISDA believes the objective of the Exposure Draft is to provide appropriate flexibility for risk managers to hedge interest rate risk within their organization. Interest rate risk may differ for a similar financial asset, financial liability, or forecasted transaction depending on how that hedged item may be managed within the organization and the risk manager’s objective in hedging its respective interest rate risk. Therefore, there are valid reasons from a risk management perspective to hedge LIBOR or Fed Funds risks for similar hedged items as the hedging relationship itself may not be considered similar when viewed in the context of broader exposures faced by the entity. Examples of when a risk manager may want to hedge both risks within its organization include the following:

1. Company ABC, a manufacturing corporation, forecasts that it will issue 10-year, fixed-rate debt in 6 months at the market rate at the time of issuance. Company ABC concludes that the LIBOR/Fed Funds Effective Swap Rate basis risk is not expected to fluctuate materially over the next 6 months. Therefore, it is neutral for this specific debt issuance as to whether its treasury department uses a forward starting LIBOR-based swap or Fed Funds-based swap to hedge the variability in cash flows caused by changes in interest rates leading up to the date of issuance. Company ABC is offered a forward starting LIBOR-based swap from Dealer 1 and a forward starting Fed Funds-based swap from Dealer 2, and determines that the pricing of the forward starting Fed Funds-based swap is more attractive. Company ABC executes the forward starting Fed Funds-based swap and formally designates the derivative in a cash flow hedge of variability in coupon payments caused by changes in the forward starting 10-year Fed Funds Effective Swap Rate. For future forecasted debt issuances, Company ABC may determine that a forward starting LIBOR-based swap is a better hedging instrument.

2. Real Estate Investment Company XYZ invests in commercial real estate. In the normal course of business, Company XYZ extends fixed-rate working capital loans to the tenants of its properties (assume notional of fixed-rate loans total \$100 million). To fund these loans, Company XYZ has a \$40 million prime-based line-of-credit and a \$60 million LIBOR-based line-of-credit secured by its properties. In order to hedge changes in the fair value of its fixed-rate loans, Company XYZ decides to swap the interest payments to a floating rate. Its research indicates that the Fed Funds Effective Rate is more highly correlated to its lender's prime rate than is LIBOR. Therefore, from a risk management standpoint Company XYZ will want to execute the following hedges: (1) \$40 million notional amount of Fed Funds-based swaps designated in a fair value Fed Funds interest rate hedge of the same notional amount of fixed-rate loans and (2) \$60 million notional amount of LIBOR-based swaps designated in a fair value LIBOR interest rate hedge of the same notional amount of fixed-rate loans.
3. Financial Holding ABC has established a treasury unit to manage the capital structure of the institution and the respective risks of that capital structure (e.g., interest rate risk and foreign exchange risk). The treasury unit issues two separate three-year, fixed-rate debt instruments in the name of Financial Holding ABC, and allocates the proceeds of one debt issuance to the broker-dealer legal entity and the proceeds of the other debt issuance to the bank legal entity of Financial Holding ABC. The broker-dealer uses the proceeds to fund Fed Funds-based assets and the bank uses the proceeds to fund LIBOR-based assets. Therefore, the treasury unit will want to hedge the interest rate risk on the debt issuance affiliated with the broker-dealer legal entity with Fed Funds-based swaps and the interest rate risk on the debt issuance affiliated with the bank legal entity with LIBOR-based swaps.

ISDA understands the restriction in paragraph 815-20-25-6 (i.e., the restriction on using different benchmark rates for similar hedges) serves as an anti-abuse measure. However, we are not aware of nor can we imagine an abuse in practice.

We believe the Exposure Draft will appropriately provide greater flexibility to risk managers to hedge different interest rate risks within their organization. Inclusion of the Fed Funds Effective Swap Rate as an eligible benchmark rate will give risk managers the opportunity to choose whether LIBOR or Fed Funds is best suited for a specific hedging relationship. We do not believe the Board intended to give risk managers more flexibility to hedge different interest rate risks and diversify the reset tenors (e.g., overnight, 1-month, 3-months) but then restrict them from using that flexibility when reasons are justified. Therefore, we recommend the Board eliminate the term "rare" in paragraph 815-20-25-6 such that different benchmark rates may be used within an organization when a risk manager's reasons are justified. We believe that despite this change in wording in the referenced paragraph, the requirement for a proper justification will continue to serve as an effective anti-abuse measure, better align guidance in paragraph 815-20-25-6 with paragraphs 815-20-25-80 and 25-81, and achieve greater convergence with IFRS (IAS 39) which does not have such a restriction. If the Board has reservations about eliminating the word "rare" in paragraph 815-20-25-6, we recommend the Board reemphasize the need to discuss

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the rationale for the choice of interest rate benchmarks in the current disclosure requirements for an entity's risk management objectives.

Aside from the above, we have no other suggested clarifications or issues with the proposed Accounting Standards Update.

## *Responses to Questions for Respondents*

### Question 1

Do you agree that the Fed Funds Effective Swap Rate (Fed Funds Effective Swap Rate) should be included as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to UST and LIBOR? Why or why not?

Yes, as described above in our overall remarks, we agree that the Fed Funds Effective Swap Rate should be an eligible benchmark interest rate for purposes of hedging relationships designated under Topic 815. Variability in overnight rates has emerged as a meaningful risk that entities monitor and seek to manage using derivatives. Accordingly, we believe there is a strong need for an overnight benchmark interest rate and the Fed Funds Effective Swap Rate best fills that need from a risk management standpoint. Given that the objective of hedge accounting is to reasonably reflect the results of an entity's risk management activities, we believe the proposed inclusion of the Fed Funds Effective Swap Rate as benchmark interest rate would be a significant improvement to Topic 815. This proposed guidance also achieves further convergence with IFRS (IAS 39) which does not prescribe which interest rates may be eligible as a benchmark rate.

### Question 2

Do you agree that no additional disclosures should be required? If not, please explain why.

Yes, we agree that no additional disclosures in the financial statements should be required. The existing disclosure requirements adequately address the objectives and results of an entity's risk management efforts and application of hedge accounting. However, as discussed above, we would be supportive of the Board reemphasizing the need to discuss the rationale for the choice of interest rate benchmarks in the current disclosure requirements for an entity's risk management objectives.

### Question 3

Do you agree that the proposed amendments only should be applied on a prospective basis for qualifying new or redesignated hedging relationships? If not, please explain why.

Yes, we agree that the proposed amendments should only be applied on a prospective basis for qualifying new or redesignated hedging relationships. Topic 815 requires that an entity define its risk management objectives at the inception of a hedging relationship and the guidance does not allow an entity to redefine aspects of its hedging relationship (e.g., the risk management objective, methods to assess and measure hedge effectiveness) without dedesignation of the original hedging relationship and redesignation of a new hedging relationship. Therefore, a retrospective application would be inconsistent with the existing requirements of Topic 815.

Question 4

Should the effective date of the amendments in the proposed Update coincide with the issuance date of a final Update? If not, when should the amendments be effective? Please explain why.

Yes, the effective date should coincide with the issuance date of the final Update. Significant demand for an overnight benchmark interest rate currently exists and entities will be able to adopt the final Update without the need for a significant transition period.

Question 5

If the effective date of the amendments in the proposed Update does not coincide with the issuance date of a final Update, should early adoption be permitted? If not, please explain why.

Yes, early adoption should be permitted if the effective date does not coincide with the issuance date of a final Update. The designation of a derivative in a hedging relationship is an election under Topic 815. An entity that is prepared to implement the proposed changes in the final Update should be permitted to do so immediately once the final Update is released.

*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.



Daniel Palomaki  
Citigroup  
*Chair, N.A. Accounting Policy Committee*