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Ms. Susan M. Cosper
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File Reference No. 2018-220
Financial Accounting Standards Board
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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* (File Reference No. 2018-220)

Dear Ms. Cosper:

We appreciate the opportunity to comment on the 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 proposal), issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's proposal to add the overnight index swap (OIS) rate based on the Secured Overnight Financing Rate (SOFR) to the list of US benchmark interest rates in Accounting Standards Codification (ASC) 815[1] that are eligible to be hedged. However, instead of limiting final guidance to the SOFR OIS rate, we believe the Board should add a broader swap rate based on SOFR that would also include tenors greater than overnight as an eligible US benchmark interest rate for hedge accounting.

In addition, we believe it is important for the Board to provide relief for existing hedging relationships based on the London Interbank Offered Rate (LIBOR) that would transition to SOFR. Without such relief, many existing hedging relationships would likely need to be discontinued before or upon transition to SOFR, given the requirements in ASC 815. In our view, such an outcome would create accounting complexity and earnings volatility that would be inconsistent with the economics of these relationships and the objective of replacing LIBOR with an improved alternative reference rate.

We applaud the Board for addressing this issue in a timely manner and believe that adding the SOFR OIS rate (or a broader SOFR-based swap rate as discussed above) as an eligible benchmark interest rate at this time could help it gain market acceptance and help constituents better prepare for the replacement of LIBOR as the predominant reference interest rate in financial contracts.

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[1] ASC 815, *Derivatives and Hedging*.

Our responses to the Questions for Respondents included in the proposal are in the appendix to this letter.

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

Very truly yours,

Ernst + Young LLP

Responses to the *Questions for Respondents* included in the FASB's proposal

Question 1: Should the OIS rate based on SOFR be included as a US benchmark interest rate for hedge accounting purposes under Topic 815? Why or why not?

We agree that the SOFR OIS rate should be included as a US benchmark interest rate for hedge accounting purposes under ASC 815, given that SOFR is intended to replace LIBOR as the predominant reference interest rate for financial instruments. Although this rate is an emerging rate, we support the Board's conclusion that it would satisfy the characteristics of a benchmark rate as defined in the Master Glossary, based on the attributes of the transaction rates in repurchase agreements that serve as the foundation for SOFR (and the SOFR OIS rate).

Question 2: Should a broader SOFR swap rate be included as a US benchmark interest rate instead of the OIS rate based on SOFR?

We support including a broader SOFR-based swap rate as a US benchmark interest rate eligible to be hedged under ASC 815. In our view, this approach would be consistent with the notion that SOFR will replace LIBOR as the primary reference interest rate in US markets and the expectation that a term structure for SOFR will develop in the marketplace. Adding a broader SOFR-based swap rate to the list of eligible US benchmark interest rates at this time may help to accelerate the market development of a SOFR term structure. It would also eliminate the need to amend ASC 815 in the future to indicate that swap rates where the variable-rate leg of the swap references a SOFR-based rate with a longer-than-overnight tenor qualify as benchmark interest rates eligible to be hedged.

In our view, these benefits outweigh any potential risks associated with this approach (e.g., that SOFR-based term rates do not develop to the point where they become widely recognized and quoted, but entities are able to designate these rates as the hedged risk). In addition, we note that the Board's rationale (as discussed in paragraphs BC 14 and BC 16 of the proposal) for why the SOFR OIS rate currently meets the characteristics of a benchmark rate would seem to also apply to a broader SOFR-based swap rate.

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.

Given the widespread use of LIBOR in the financial markets, the transition to SOFR as the predominant reference interest rate for financial instruments would affect entities in all industries and raise a number of accounting questions. As a result, we support the Board providing relief to help entities address the accounting implications associated with this transition. From a hedge accounting perspective, we believe transition guidance could be useful for both existing and newly designated hedging relationships.

If the Board does not provide relief, many existing hedging relationships would likely need to be discontinued upon transition to SOFR due to the requirement in ASC 815-20-55-56 that a hedging relationship be dedesignated and redesignated if an entity wishes to change any of the critical terms of the relationship.

It is our understanding that the International Swaps and Derivatives Association is developing a protocol to help facilitate the transition of LIBOR-indexed derivative contracts to SOFR. This protocol is expected to result in the reference rate indexed in the derivative (e.g., the rate indexed in the variable leg of an interest rate swap) being changed from LIBOR to SOFR plus a spread. Adding a spread would be necessary in order for the current fair value of the derivative instrument to remain unchanged because the credit risk embedded in SOFR would generally be lower than that of LIBOR.

Without transition guidance from the Board, the application of this protocol to derivatives that serve as hedging instruments would likely require a dedesignation of the hedging relationships due to a change in a critical term. The need to dedesignate and redesignate existing hedging relationships could have various implications depending on the nature of the hedge. For example, it could result in increased earnings volatility associated with redesignated fair value hedges when the change in fair value of the hedged item is based on the benchmark rate component of the contractual coupon cash flows. This would be the case because the fixed rate on the amended interest rate swap (whose terms have been changed from LIBOR to SOFR) would not equal the SOFR-based swap rate as of hedge inception (i.e., the redesignation date). In addition, entities would be unable to continue to apply the shortcut method because the hedging instrument would not have a fair value of zero on the redesignation date.

For existing cash flow hedges of financial risk, the transition from LIBOR to SOFR could affect the hedged item, in addition to the hedging instrument, resulting in additional accounting implications. For example, depending on how narrowly or broadly the hedged item has been defined, questions may arise about whether (or when) forecasted interest payments/receipts based on LIBOR would no longer be deemed probable of occurring, resulting in a need to discontinue hedge accounting. In addition, if the forecasted LIBOR-based interest payments/receipts originally expected to occur after 2021 are determined to be probable of not occurring (i.e., because LIBOR will no longer be supported), an entity would be required to reclassify the amounts in other comprehensive income related to these forecasted transactions into earnings. Without transition relief, one might reach this conclusion even when the hedging instrument and the hedged item are both expected to transition from LIBOR to SOFR so that the hedging relationship is expected to continue to be highly effective.

We are concerned about the accounting complexity and earnings volatility that would result from not providing transition relief. We believe these outcomes would be inconsistent with the economics of these relationships and the objective of replacing LIBOR with an improved alternative reference rate. That is, financial reporting would not be improved. We therefore believe the Board should provide transition relief that would allow existing hedging relationships to continue uninterrupted if these relationships continue to be consistent with an entity's risk management objectives. The FASB could accomplish this by including an overarching principle in any final guidance that a change from LIBOR to SOFR should not, in and of itself, result in hedging relationships being discontinued, along with other more specific guidance addressing the particular issue in question. For example, the FASB could state explicitly that the hedged risk in existing fair value hedging relationships, along with the related benchmark rate component cash flows in the hedged item, can be changed from LIBOR to SOFR without dedesignating the hedging relationship.

Transition guidance may also be needed for new hedging relationships to address some of the practical challenges that could result from the transition to SOFR. For example, there may be questions about how to define the hypothetical derivative in a cash flow hedge of variable rate debt that is entered into at some point in the future (e.g., in 2019) when there is an expectation that certain variable interest payments will be based on LIBOR while others will be based on SOFR.

Regardless of the approach that the Board decides to take regarding transition relief for hedge accounting, we believe it should be flexible enough to deal with the various issues that may arise from the transition to SOFR with limited disruption to financial reporting.

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

We generally do not believe that the proposal should require any additional disclosures, which would be consistent with the approach taken by the FASB when it issued Accounting Standards Update (ASU) 2013-10[2] to add the Fed Funds OIS rate as a benchmark interest rate that is eligible to be hedged.

If the Board decides to provide transition relief for existing hedging relationships, it may want to consider whether any transition-related disclosures would be helpful for users of financial statements. However, we believe the disclosure requirements in ASC 815 would likely be sufficient to explain any transition effects.

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.

We agree that the guidance should be applied prospectively to new and redesignated hedging relationships.

However, we also believe that entities should be allowed to designate SOFR OIS (or another SOFR-based swap rate) as the hedged risk in existing hedging relationships that do not have to be redesignated upon transition to the new rate. We note that existing hedging relationships would not have to be redesignated if the FASB follows our recommendation (in our response to Question 3) to provide transition relief that would limit the need to dedesignate and redesignate a hedge when an entity switches from LIBOR to SOFR OIS (or another SOFR-based swap rate). If the Board agrees, we recommend that changes to existing hedging relationships be applied prospectively as well.

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[2] 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 (a consensus of the FASB Emerging Issues Task Force)*.

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.

We do not see a compelling reason why the effective date of the proposal needs to coincide with that of ASU 2017-12.[3] Instead, we believe the effective date of the proposal should coincide with the issuance date of a final ASU, consistent with the approach taken by the Board when it issued ASU 2013-10. Depending on how quickly a market develops for SOFR-based swap rates, an entity may wish to hedge the SOFR OIS rate (or a broader SOFR-based swap rate, as discussed above) as a benchmark rate before it adopts ASU 2017-12, and we see no obvious reason why this should be precluded.

3 ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*.