JPMORGAN CHASE & CO.

June 15, 2018

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Agenda Request – Exclusion of LIBOR / OIS basis from the assessment of hedge effectiveness for fair value hedges of interest rate risk

Dear Ms. Cosper:

JPMorgan Chase & Co. (the "firm") commends the Board for its recently issued Accounting Standards Update (ASU) 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities,* and believes that it will improve the financial reporting of hedging relationships to better portray the economic results of risk management activities in financial statements. We appreciate the opportunity to submit an agenda request to address the accounting for fair value hedges of benchmark interest rate risk in which the designated benchmark interest rate differs from the interest rate used to discount the cash flows of the hedging instrument.

This practice issue was outside the scope of the discussions that led to the issuance of ASU 2017-12, and has taken on added importance given the introduction of the ability to measure the change in fair value of the hedged item on the basis of the benchmark interest rate component of the contractual coupon cash flows at hedge inception, which has reduced other sources of hedge ineffectiveness. We believe this is a pervasive issue across industries, narrow in nature, and can be resolved in a short time frame. The Board also acknowledged during deliberations for ASU 2017-12 that issues incremental to that project could be considered by the Board at a subsequent time; therefore, we believe the timing of this request is now appropriate.

This letter provides our firm's agenda request and views on why this topic should be added to the agenda. To facilitate the Board's review of this agenda request, this letter includes: (1) the background and the firm's view on this practice issue, and (2) the nature of amendments that could be made to the Codification to illustrate that only narrow changes are necessary.

Background

Hedged Item

In a fair value hedge of benchmark interest rate risk, the cash flows of the hedged item are required to be present valued using a discount rate that reflects the changes in the designated benchmark interest rate, as per ASC 815-25-55-57 and 815-25-55-61A. For many hedge relationships, this designated benchmark continues to be LIBOR, given its current benchmark status, the preponderance of LIBOR risk inherent in preparer balance sheets, and the availability of liquid LIBOR derivative markets. For those hedge relationships, the hedged items' cash flows are thus discounted at LIBOR flat or LIBOR plus the market spread at hedge inception.

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Hedging Instrument

At the time of the deliberations of SFAS 133 and SFAS 138, the market convention for valuing LIBOR interest rate swaps was to discount the swap cash flows using a LIBOR curve. However, the current prevalent market convention is to discount cleared and non-cleared interest rate swap cash flows using overnight rates of interest (e.g., OIS), because interest on collateral posted to the counterparty or clearinghouse against the relevant swap(s) is determined on the basis of overnight rates. Therefore, for relationships designated as LIBOR benchmark interest rate risk hedges, there is a difference in the curves used to discount the cash flows of the hedged item (LIBOR) and the hedging instrument (OIS), due to the hedging instrument's collateral requirements.

Discount Rate Difference

The use of different discount rates in the valuation of the hedged item and the hedging instrument can result in meaningful ineffectiveness, depending on the notional size and tenor of the hedging relationship, and on the volatility of the LIBOR/OIS basis. This source of ineffectiveness has increased in importance due to the reduction of other sources of ineffectiveness in ASU 2017-12.

Prior to ASU 2017 – 12, preparers were required to measure the change in the fair value of the hedged item in a fair value hedge of benchmark interest rate risk on the basis of the total contractual coupon cash flows of the hedged item. In notional-matched total contractual coupon hedges, the ineffectiveness due to the difference between the fixed coupon rate of the swap versus that of the hedged debt instrument typically significantly exceeded the ineffectiveness contributed by LIBOR/OIS basis. Preparers dealt with the potential ineffectiveness in different ways – those who used notional-matched hedges explained any ineffectiveness material to their earnings results, while others adjusted the hedge ratio to minimize the ineffectiveness that would result from rate differences at inception. However, adjusting the hedge ratio at inception would not eliminate ineffectiveness resulting from LIBOR/OIS basis changes over time and would require re-adjustment or explanation if significant.

ASU 2017-12 now permits an entity to measure the change in fair value of the hedged item on the basis of the benchmark rate component of the contractual coupon cash flows at inception, thereby eliminating ineffectiveness from the fixed coupon rate difference that had been present under the total contractual coupon method. Preparers who had been adjusting their hedge ratio prior to adoption of ASU 2017-12 may wish to adopt the benchmark rate component approach in order to eliminate this source of ineffectiveness entirely, and to simplify their hedge accounting operations. However, given that ineffectiveness from LIBOR/OIS basis remains unaddressed, and can potentially be significant in notional-matched hedge relationships, some preparers may wish to continue to adjust the hedge ratio to reduce at least some of the LIBOR/OIS ineffectiveness, thereby foregoing the operational benefit offered by the benchmark component approach.

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Proposed Solution

If the Board concludes this practice issue should be added to the agenda for further deliberation, we believe that the ineffectiveness from discount rate basis differences in fair value hedge relationships can be addressed by permitting the LIBOR/OIS basis to be considered an excluded component in a narrow amendment to the Codification, below.

> **815-20-25-82** In defining how hedge effectiveness will be assessed, an entity shall specify whether it will include in that assessment all of the gain or loss on a hedging instrument. An entity may exclude all or a part of the hedging instrument's time value from the assessment of hedge effectiveness, as follows:
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> > f. An entity may exclude the portion of the change in fair value of an interest rate swap attributable to the change in basis between the benchmark interest rate and the swap's discount rate.

Conclusion

Given the views expressed above and the impact of this issue across many preparers, the firm believes that the accounting for fair value hedges of benchmark interest rate risk in which the designated benchmark interest rate differs from the interest rate used to discount the cash flows of the hedging instrument is a topic that would be worthwhile for the Board to address. By addressing this issue, the Board may more fully meet the objectives of ASU 2017-12 to help financial statements better reflect risk management activities and to ease the application of hedge accounting guidance.

We appreciate the opportunity to request the Board's consideration of this issue and would welcome the opportunity to discuss further. Should you have any questions or desire further clarification on any of the matters discussed in this letter, please do not hesitate to contact me or Laurin Smith at (212) 648-0909.

Sincerely yours,

Bret Dooley

Bret Dooley
Managing Director
Corporate Accounting Policies