



November 14, 2019

Mr. Shayne Kuhaneck
Acting Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: FASB Agenda Request — Application of ASC Topic 815 to Call Option Monetization Hedging Strategies

Dear Mr. Kuhaneck

We are writing you regarding the application of ASC Topic 815 (as amended by ASU 2017-12) to an interest rate hedging strategy involving the monetization of call options embedded within callable fixed rate debt (herein referred to as “call option monetization”) that has been considered by a number of our clients during the last year in light of the current interest rate environment. The principal purpose of our outreach to the Financial Accounting Standards Board (FASB) is to request that the FASB add to its Technical Agenda a review of the current ASC Topic 815 guidance on the aforementioned hedging strategy and consider proposing limited scope amendments to Topic 815 that would afford companies that execute call option monetizations the ability to apply the “benchmark interest rate component” guidance that was included in ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities*.

The basis for this request is that the FASB hedging project that culminated in the issuance of ASU 2017-12 did not re-examine the application of the fair value hedging model pertaining to callable fixed-rate debt instruments where the embedded call option is hedged with a written call option that is indexed to “benchmark interest rates” such as U.S. Dollar LIBOR. ASC Topic 815 (815-25-55-29) requires such a hedge to be designated as a hedge of total changes in fair value (including the issuer’s own credit risk) even though the hedging entity is only economically hedging exposure to benchmark interest rates (through the sale of an interest rate option). In contrast, ASU 2017-12 permits identification of the benchmark interest rate component of a callable debt instrument’s contractual cash flows (both coupons and call options) as the hedged item (and a benchmark interest rate as the hedged risk) when such debt is swapped to floating with a cancellable fixed-for-floating interest rate swap. We believe that the retention of the requirement to identify total changes in fair value of the embedded call option as the hedged risk when the hedging instrument is solely a written interest rate option may have been unintentional given that ASU 2017-12 allowed companies to isolate component risks from an array of hedged items including financial and nonfinancial transactions. Retaining the guidance in 815-25-55-29 has resulted in materially disparate accounting treatment for economically similar hedges (other than the coupon structure). Moreover, the FASB’s objectives in issuing ASU 2017-12 were to (i) better align financial reporting with an entity’s risk management objectives and (ii) simplify the application of the hedge accounting guidance in Topic 815. As described more fully below, the requirement to measure and report total changes in fair value of an embedded call option within callable debt that is hedged by the issuer with a written interest rate option does not reflect a typical company’s risk management objectives and results in significant operational and accounting complexity. For these reasons, we request that the FASB reconsider this area of Topic 815 through a narrow-scope project.

Overview

U.S. companies often issue fixed rate callable debt as part of their financing strategy to diversify their investor base yet maintain an attractive cost of funds. These companies may choose to keep the callable debt in its natural format, or depending on their risk management objectives, may hedge the interest rate risk associated with the debt by either:

- Swapping the debt to floating with a cancellable interest rate swap that is cancellable by the bank counterparty on the same terms as the debt (herein referred to as a “floating rate call option monetization”), or
- Maintaining the debt’s fixed rate profile but monetizing the embedded call options within the debt by selling an interest rate option (a swaption) to a bank counterparty that gives the bank the right to receive fixed and pay floating when the LIBOR swap rate falls below a specific level (herein referred to as a “fixed rate call option monetization”)

The core objective of the two strategies described above is that the company is seeking to hedge its exposure to variability in benchmark interest rates (generally, U.S. Dollar LIBOR). The key decision for whether a company that has issued callable debt executes a floating rate call option monetization or a fixed rate call option monetization is the amount of floating rate debt it needs to maintain its targeted fixed vs. floating rate debt mix. Additionally, the level of interest rates and the shape of the yield curve may influence a company in deciding whether to execute a floating rate or fixed rate call option monetization. The influence of these factors on hedging strategy is summarized below:

Curve Steepness / Level of Rates	Hedge Strategy
Steep, upward sloping yield curve; higher interest rates	Floating rate monetization
Flat or inverted yield curve; lower interest rates	Fixed rate monetization

The accounting for floating rate call option monetizations is not specifically illustrated in ASC Topic 815; however, such hedging strategy can qualify for the shortcut method guidance as long as the criteria in ASC 815-20-25-104(c) and 104(e) are met. The accounting for fixed rate monetizations was included as an example in the original FASB Statement No. 133, *Derivatives and Hedging* (FAS 133), and has been included in the Accounting Standards Codification in ASC 815-815-25-55-27 through 55-29. Further, the rationale for why the FASB Board permitted written interest rate options to be designated as hedges of embedded call options was reflected in the FASB Board’s Basis for Conclusions in the original FAS 133, which is summarized below.

Respondents to the Exposure Draft objected to categorically prohibiting written options from being designated as hedging instruments. A number of respondents specifically referred to the use of a written option to hedge the call option feature in a debt instrument. They explained that it may be more cost effective to issue fixed-rate, callable debt and simultaneously enter into a receive-fixed, pay-variable interest rate swap with an embedded written call option than to directly issue variable-rate, noncallable debt. The Board agreed that hedge accounting should be available for that use of written options. Consequently, this Statement permits designation of a written option as hedging the purchased option embedded in a financial instrument. The Board

notes that if the option features in both instruments are exactly opposite, any gains or losses on the two options generally will offset. Section 2 of Appendix A includes an example illustrating such a strategy. [Emphasis added]

Accounting for Call Option Monetizations

Floating Rate Call Option Monetizations

As noted above, floating rate call option monetizations can qualify for application of the shortcut method as long as all of the criteria for application of that method set forth in ASC 815-20-25-104 through 25-105 are met. Under the legacy (pre-ASU 2017-12) and current shortcut method guidance, companies swapping fixed-rate callable debt to floating generally are permitted to ignore credit risk when assessing hedge effectiveness and measuring ineffectiveness/hedge results per ASC 815-20-25-111. As such, floating rate call option monetizations accounted for under the shortcut method historically have not needed to consider changes in the company's own credit risk when measuring changes in fair value of the hedged item.

Certain companies applied the "long-haul" method to floating rate monetizations prior to the adoption of ASU 2017-12 (which was done for various reasons including the risk of restatement if their application of the shortcut method were to be challenged) and continue to apply long-haul because they did not wish to close out their prior hedge and execute a zero fair value cancellable swap upon adoption of ASU 2017-12. Under the legacy long-haul accounting treatment, there was a long running debate as to whether a company's own credit risk needed to be factored into the company's assessment and measurement of hedge ineffectiveness. This debate involved two primary views:

- View 1: ASC 815's explicit ability to solely designate changes in a benchmark interest rate associated with fixed-rate callable debt that is swapped to floating with a cancellable swap was the basis for not requiring changes in own-credit to be reflected in changes in fair value of the hedged item
- View 2: The reference in the guidance illustrating a fixed rate call option monetization (ASC 815-25-55-29) that requires the hedged risk to be total changes in fair value (including the hedging entity's own credit risk) is the basis for requiring the cancellable swap fair values to reflect changes in credit risk.

Prior to the issuance of ASU 2017-12 audit firms were comfortable with a client's application of View 1 above to floating rate monetizations accounted for under the long-haul method. ASU 2017-12 amended ASC Topic 815 by explicitly allowing companies to isolate the benchmark interest rate component of a fixed rate debt instrument as the hedged item (as illustrated in ASC 815-25-55-61A through 55-61C), and also amended ASC Topic 815 by explicitly allowing companies to exclude changes in all factors other than a benchmark interest rate when measuring changes in fair value of a prepayable debt instrument (ASC 815-20-25-6B). As such, the assessment of hedge effectiveness and measurement of hedge results for floating rate call option monetizations accounted for under long-haul post adoption of ASU 2017-12 can exclude changes in a company's own credit risk, which better reflects the company's risk management strategy and the actual economics of the hedge executed.

Fixed Rate Call Option Monetizations

Fixed rate call option monetizations are not eligible for the shortcut method because they solely involve a written swaption and not an interest rate swap. However, we would like to highlight that a written swaption hedging instrument that is used in a fixed rate call option monetization is substantially the same as the written swaption embedded within a cancellable interest rate swap that would be designated in a floating

rate call option monetization. The only difference is the timing of the premium payment; under the former strategy it is paid at inception while the premium under the latter strategy is paid over a time via a lower floating leg spread.

ASC 815-25-55-29 requires that when the hedged item is an embedded call option and the hedging instrument is a written option, the hedged risk must be total changes in fair value. Even though a company's risk management objectives with regards to the embedded call option may be the same whether executing a floating rate call option monetization or a fixed rate call option monetization (which objectives generally are to monetize an option indexed to a benchmark interest rate), when a company chooses to keep the interest rate profile of its callable debt in fixed rate format, it is precluded from identifying the benchmark interest rate component of the hedged embedded call option as the hedged risk. The guidance that cites this requirement is set forth immediately below.

Because this Subtopic does not permit derivative instruments, including embedded derivatives whether or not they are required to be accounted for separately, to be separated into components, Entity F can only designate a hedge of the entire change in fair value of the embedded purchase call option...Any mismatch between the changes in fair values of the hedging instrument and the hedged item attributable to the hedged risk...will be automatically reflected in earnings (because the premium for the written call option is unlikely to be the same as the premium for the embedded purchased call option).

However, the FASB did not distinguish in its Basis for Conclusions of FAS 133 between fixed and floating rate call option monetizations and noted the following in paragraph 397.

The Board agreed that hedge accounting should be available for that use of written options. Consequently, this Statement permits designation of a written option as hedging the purchased option embedded in a financial instrument...The Board notes that if the option features in both instruments are exactly opposite, any gains or losses on the two options generally will offset."

We note that if a company had to reflect changes in its own credit risk in the value of the embedded call option it is not clear how well the written swaption (only sensitive to a benchmark interest rate such as LIBOR) would offset total changes in fair value of the embedded call option. Recently, we have worked with several U.S. clients that are issuers of long-dated callable debt that want to execute fixed rate call option monetizations. While these clients can execute floating rate call option monetizations and attain streamlined accounting doing so would exceed their floating rate debt limits. In working with these clients to establish whether a written LIBOR-based swaption (which has substantially similar economics to a cancellable swap with matching options) would be highly effective in offsetting total changes in fair value of the client's embedded call options we observed that, depending on the period during which the changes in value were calculated, the hedge may only marginally qualify for hedge accounting (even when all of the monetary terms of the embedded and written options matched). This is in stark contrast to the FASB Board's conclusions in FAS 133, which highlighted that if the option features of both instruments match, the gains or losses of the two options generally will offset. Additionally, the potential ineffectiveness that could arise due to the requirement to reflect changes in the company's own credit risk could be significant. This ineffectiveness would contribute to distortions in reported earnings and is not reflective of economic reality, as the company is only seeking to monetize the benchmark interest rate component of the embedded option (which is the only risk that can be hedged in the market). Further, this issue can be exacerbated depending on the timing of the monetization (i.e., whether it occurs at issuance vs. after issuance). It would seem that this type of accounting result is counter to the FASB's stated objectives in its issuance of ASU 2017-12.

We also would like to highlight what is required to actually reflect changes in a company's own credit risk in the ongoing valuations of the embedded call option. Most callable debt instruments issued involve long-dated debt with original maturities ranging from 30-50 years. While there is meaningful liquidity in long-dated interest rate options indexed to LIBOR there is no active market for long-dated corporate bond options (in fact post the recent financial crisis there is virtually no observable liquidity in corporate bond options of any term). As such, to estimate the fair value of long-dated embedded call options requires making significant judgments about certain critical inputs such as credit spread volatility which substantially increases the risk of estimation error and may also result in inconsistent application of the guidance. Specifically, there is no observable term structure of credit spread volatility and thus a volatility surface can only be constructed from implied interest rate volatility (which may not be directly correlated to an individual company's credit spreads). In addition to generating reasonable and supportable valuation inputs for the embedded call option, companies then need to be able to operationalize the valuation process to support initial and ongoing effectiveness tests. This effort cannot be underestimated and likely will require companies to incur substantial costs if they were to acquire the valuation tools needed to perform the accounting analysis that is specific to this hedging strategy. For example, the derivative valuation systems to which typical corporate derivative end-users have access generally would not be capable of simulating historical option values considering both interest rate and credit risk; therefore, they would need to acquire additional licenses to gain access to these valuation tools. Assuming that a company acquires the data necessary to perform the effectiveness tests and establishes that the hedge is highly effective, it would still be required to record changes in fair value of the embedded option based on a proxy that may not be truly representative of the price at which a true bond option would trade in the market (assuming such a market existed). As such, the valuation process currently required in ASC 815-25-55-29 is not only a poor reflection of a company's actual risk management strategy (which is to solely hedge a benchmark interest rate) but also potentially reduces the relevance and reliability of the financial statements.

The guidance contained in ASC 815-25-55-29 was not amended by ASU 2017-12, even though the FASB Board decided to allow companies to isolate the benchmark interest rate component of a fixed rate debt instrument's coupon cash flows and allow companies to isolate changes in the fair value of prepayable debt instruments due solely to changes in a benchmark interest rate as the hedged risk. Additionally, the FASB amended Topic 815 to allow companies that are seeking to hedge nonfinancial exposures (such as commodity purchases or sales) to isolate nonfinancial risk components and identify such components as the hedged risk despite the fact that FAS 133 prohibited this due to a reliability concern.

While the FASB's intent regarding the retention of the guidance in ASC 815-25-55-29 is unclear, we strongly encourage the Board to consider adding a narrow scope project to its Technical Agenda (we believe this matter may be something that can be addressed by the Emerging Issues Task Force) to reexamine this guidance by amending Topic 815 to allow companies to identify the benchmark interest rate component of an embedded call option within callable fixed rate debt as the hedged item and permit the benchmark interest rate to be designated as the hedged risk in a fixed rate call option monetization. If the Board is not open to permitting identification of the benchmark rate component of the embedded call option as the hedged item in a fixed rate call option monetization, then we would ask that the FASB consider permitting companies to designate a benchmark interest rate as the hedged risk (and thus permit companies to consider only changes in a benchmark interest rate when measuring changes in fair value of the embedded call option) in these hedge relationships. In the U.S. there are over 15 nonfinancial corporations that have issued over \$24 billion in aggregate principal of callable debt that remains outstanding as of November 2019¹ (including callable debt issuers that are U.S. financial institutions would expand the total number of issuers

¹ Estimated based on Bloomberg

to over 25 and aggregate outstanding callable debt obligations to \$65 billion). As such, this accounting issue is relevant to a relatively large number of corporate issuers and additional guidance would be an improvement to these issuers' accounting should they decide to execute fixed rate call option monetizations.

We would be happy to share additional perspectives and suggestions with the Board and FASB staff on the matter discussed in our agenda request. If you have any questions concerning this request, please contact Jon Tkach, Director, Capital Markets and Risk Solutions at 212-526-4515, Manay Patel, Managing Director, Head of Americas Risk Solutions Group, or Kiery Tuttle, Managing Director, Risk Solutions Group, at 212-526-1412.