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To the Point

FASB – final guidance

FASB adds new benchmark interest rate for hedge accounting

The addition of the SOFR OIS rate as an eligible benchmark interest rate could help broaden its acceptance in the marketplace.

What you need to know

- The FASB issued final guidance that adds the overnight index swap rate based on the Secured Overnight Financing Rate to the list of US benchmark interest rates in ASC 815 that are eligible to be hedged.
- As a result, entities may designate changes in this rate as the hedged risk in hedges of interest rate risk for fixed-rate financial instruments.
- The Secured Overnight Financing Rate was identified as the preferred reference rate alternative to the London Interbank Offered Rate in the US by a committee convened by the Federal Reserve Board and the Federal Reserve Bank of New York.
- The guidance is effective when an entity adopts the new hedging guidance in ASU 2017-12. Entities that have already adopted ASU 2017-12 may begin to apply this guidance in any interim period.

Overview

The Financial Accounting Standards Board (FASB or Board) issued final guidance[1] amending Accounting Standards Codification (ASC or Codification) 815[2] to add the overnight index swap (OIS) rate based on the Secured Overnight Financing Rate (SOFR) to the list of US benchmark interest rates that are eligible to be hedged. ASC 815 allows entities to designate as the hedged risk changes in the fair values or cash flows of existing or forecasted fixed-rate financial assets or liabilities attributable to a benchmark interest rate. A benchmark interest rate is the portion of the total interest rate that excludes any credit spread.

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Background

Amid concerns about the sustainability of the London Interbank Offered Rate (LIBOR), the Federal Reserve Board (Fed) and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (ARRC) in 2014 to identify suitable alternative reference interest rate(s) to LIBOR and develop an adoption plan to facilitate the acceptance and use of the alternative rate(s). The ARRC identified SOFR, a broad Treasury repurchase agreement (repo) financing rate, as the preferred reference interest rate alternative to LIBOR and announced a transition plan to integrate this rate into the financial markets. The Federal Reserve Bank of New York began publishing the daily SOFR in the second quarter of 2018.

The FASB's new guidance comes in response to a request from the Fed. The Fed believes that including this rate in the list of acceptable benchmark rates for hedge accounting purposes represents an important step in broadening its acceptance in the marketplace. There are similar initiatives around the globe to identify reference interest rate alternatives to the respective Interbank Offer Rates that are widely used in different jurisdictions. For example, the Sterling Overnight Index Average (SONIA) was identified as the preferred reference interest rate alternative to British pound sterling LIBOR.

However, ASC 815 does not need to be amended to add foreign alternative reference interest rates as benchmark rates because US GAAP does not provide prescriptive guidance on eligible benchmark rates for non-US dollar interest rates. Instead, entities rely on the definition of a benchmark interest rate in the Master Glossary of the Codification to determine the foreign currency interest rates that are deemed to qualify for designation as the hedged risk in hedges of non-US dollar interest rate risk.

Key considerations

The new guidance adds the SOFR OIS rate to the following list of US benchmark interest rates that may be designated as the hedged risk in hedges of fixed-rate financial instruments:

- Direct Treasury obligations of the US government
- The LIBOR swap rate
- The OIS rate based on the Fed Funds Effective Rate
- The Securities Industry and Financial Markets Association municipal swap rate

The new guidance defines the SOFR OIS rate as "[t]he fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Secured Overnight Financing Rate (SOFR) (an overnight rate) with no additional spread over SOFR on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the variable cash flows."

That is, the SOFR OIS rate represents the fixed rate on an interest rate swap whose variable-rate leg is based on the overnight SOFR. Although the SOFR OIS rate may not currently be a widely recognized and quoted rate, the FASB believes it satisfies the characteristics of a benchmark rate based on the attributes of the repo transaction rates that support SOFR (and the OIS rate based on SOFR).

The FASB decided to add only the SOFR OIS rate to the list of benchmark rates eligible to be hedged at this time, rather than a broader SOFR swap rate that would be the equivalent of the LIBOR swap rate and cover various tenors (e.g., the fixed rate on an interest rate swap where the variable-rate leg references three-month SOFR).

The FASB concluded that a swap rate based on a SOFR term rate did not currently meet the characteristics of a benchmark interest rate because it would not be based on actual transactions since neither derivative nor cash instruments referencing a SOFR term rate currently exist. In addition, the FASB noted that the ARRC's transition plan currently anticipates introducing only OIS swaps referencing SOFR in the marketplace in the near term.

However, the Board has stated that it plans to monitor developments in this area and is prepared to consider adding a broader SOFR-based swap rate as an eligible benchmark interest rate to be hedged if SOFR term rates emerge in the marketplace.

Disclosures, transition and effective date

No additional disclosures are required under the new guidance, consistent with the FASB's approach when it previously added new US benchmark rates to ASC 815.

Entities may apply the amendments to new or redesignated hedging relationships entered into on or after the date of adoption. The new guidance does not address changes to existing hedging relationships upon a transition to SOFR OIS from LIBOR, but the Board added a project to its agenda to consider transition relief provisions for existing hedging relationships, noting that additional time is needed to fully consider the implications of transitioning existing LIBOR-based financial instruments to SOFR.

The FASB plans to consider transition relief for existing hedges in a separate project.

As part of this project, the FASB plans to broadly consider other changes to US GAAP that may be necessitated by a market-wide transition to SOFR from LIBOR, with the objective of helping to facilitate this transition.

How we see it

Without transition relief, many existing hedging relationships would likely need to be discontinued upon transition to SOFR because ASC 815 requires a hedging relationship to be dedesignated and redesignated if an entity wishes to change any of the critical terms of the relationship.

The need to dedesignate and redesignate existing hedging relationships could have various financial reporting 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 the fair value of the hedged item is based on the benchmark rate component of the contractual coupon cash flows.

In our view, the accounting complexity and earnings volatility that would result absent any transition relief is inconsistent with the economics of these relationships and the objective of replacing LIBOR with an improved alternative reference rate. Therefore, we support the FASB's decision to consider changes to US GAAP that may be needed to facilitate a smooth transition from a financial reporting perspective.

Entities that have not yet adopted the new hedging guidance in Accounting Standards Update (ASU) 2017-12[3] will apply the new amendments when they adopt ASU 2017-12. For public business entities that have already adopted ASU 2017-12, the amendments are effective for fiscal years beginning after 15 December 2018, and interim periods within those fiscal years. For all other entities that have adopted ASU 2017-12, the amendments are effective for fiscal years beginning after 15 December 2019, and interim periods within those fiscal years. Early adoption, including adoption in an interim period, is permitted, as long as the entity has adopted ASU 2017-12.

Endnotes:

[1] ASU 2018-16, *Derivatives and Hedging (Topic 815), Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes*.

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

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