October 7, 2019

Mr. Shayne Kuhaneck
Acting Technical Director
File Reference No. 2019-770
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Via email: director@fasb.org

RE: Proposed Accounting Standards Update, Reference Rate Reform (Topic 848) - Facilitation of the Effects of Reference Rate Reform on Financial Reporting

File Reference No. 2019-770

Dear Mr. Kuhaneck:

Capital One Financial Corporation (“Capital One”)1 appreciates the Board’s continued responsiveness to implementation concerns raised by stakeholders and the opportunity to provide comments on the Exposure Draft, Proposed Accounting Standards Update, Reference Rate Reform (“the Exposure Draft”). We support the Board’s efforts to provide transition relief for Reference Rate Reform and ask that you consider the suggestions provided below.

Contract Modifications

We appreciate the Board’s swift response to rate reform and for the continued monitoring of recent market developments. We support the optional contract modification expedients provided and seek additional clarity on the following topics.

Spread Adjustment

As a result of the transition, companies will be required to migrate from a legacy reference rate to a replacement reference rate, typically including a spread adjustment. ASC 848-20-15-5(b) references spread adjustments without explicitly providing the method for calculating the value attributed. The current guidance can be interpreted to say that only a ‘spot’ spread adjustment between reference rates is an acceptable method. Industry standards have begun development around the spread adjustment, which is not isolated to a spot spread difference. ISDA has proposed using a historical mean/median approach that would take the mean/median of the spread over a historical period of time, which might not be consistent with the guidance, as stated. Further, ARRC fallback language for certain products

---

1 Capital One Financial Corporation (www.capitalone.com) is a financial holding company whose subsidiaries, which include Capital One, N.A., and Capital One Bank (USA), N.A., had $254.5 billion in deposits and $373.6 billion in total assets as of June 30, 2019. Capital One, N.A. has branches located primarily in New York, New Jersey, Texas, Louisiana, Maryland, Virginia, and the District of Columbia. A Fortune 500 company headquartered in McLean, Virginia, Capital One trades on the New York Stock Exchange under the symbol “COF” and is included in the S&P 100 index.
includes a use of spread adjustments based on term SOFR/forward rates (which also might not be consistent with the current language). We would therefore request clarity on the allowable spread that would meet the ‘related to the replacement of a reference rate’ criteria.

**Variable Rate to Fixed Rate**

In paragraph 24 of the Basis for Conclusions, it was indicated that a change from a variable rate to a fixed rate would not be eligible for contract modifications expediens since a negotiated fixed rate includes spread components that would reflect a credit decision that is separate from reference rate reform. However, contract modifications could apply the expedient if the fixed rate was predetermined based on the most recent reset of a variable rate affected by reference rate reform. We would like to suggest that this information be included under ASC 848-20-15-5(a), instead of included in the Basis for Conclusion.

**Debt Exchanges or Modifications Made within a Year of the Current Modification**

As proposed, ASC 848-20-35-9 states that modifications related to rate reform should be considered ‘substantially different’ as discussed in ASC 470-50-40-12f. The guidance states that if a debt instrument is restructured more than once in a twelve month period, a cumulative assessment of all restructurings in the period should be done if the earlier restructuring was not accounted for as an extinguishment. If the Company completes a debt modification upon adoption of ASC 848 or thereafter, we would request clarity that the proposed guidance supports the use of the contract specifics from the rate reform adoption as the starting point of our assessment.

Furthermore, we request clarity on the guidance that should take precedence if a change related to rate reform and a change unrelated to rate reform, occur at the same time. Providing an example in this area might be beneficial and reduce potential uncertainty upon adoption.

**Hedging**

We are generally in agreement with the Board on the proposed optional expedients for hedging relief and seek clarification on the following areas noted.

**Cash Flow Hedge - Hedged Item Modifications**

The Company has certain commercial loans that are indexed to USD LIBOR. After the adoption of the final reference rate reform guidance, the Company may modify the commercial loans with the addition of out-of-the-money floors to manage the interest rate exposure. These out-of-the-money floors would qualify for the relief provided in the contract modification section, as referenced in the exposure draft paragraph 848-20-15-6f. The Company is seeking further clarification on the treatment of the modification to the hedged item in an existing cash flow hedge relationship; specifically, whether it is

---

2 ASC 848-20-15-5(a): Changes to the referenced interest rate index (for example, a change from London Interbank Offered Rate [LIBOR] to another interest rate index)

3 ASC 848-20-35-9: If the optional expedient in paragraph 848-20-35-7 is elected, an entity that applies the 10 percent cash flow test described in paragraph 470-50-40-17-10 for any subsequent contract modification shall consider a modification in paragraph 848-20-35-7 to be substantially different from other exchanges or modifications within a year for the purpose of paragraph 470-50-40-12(f).

4ASC 470-50-40-12(f): If within a year of the current transaction the debt has been exchanged or modified without being deemed to be substantially different, then the debt terms that existed a year ago shall be used to determine whether the current exchange or modification is substantially different.
permissible to disregard out-of-the-money options from the subsequent measurement of the hedged item and the effectiveness assessment. We think the current language in the exposure draft is unclear on whether the Company needs to modify the hypothetical derivative to reflect modifications to the hedged item within the scope of this guidance.

The Company will consider the risk management rationale to modify financial assets with out-of-the-money options to help manage the transition period interest rate exposure. If the addition of out-of-the-money options is required to be included in the subsequent quantitative effectiveness assessment, it would be contrary to the underlying principle of the current proposal (contract modifications within the scope of this guidance are deemed to be continuations of existing contracts). The Company believes the principle should be applied consistently to modifications to the hedged item for hedging purpose as well. To facilitate the smooth transition, the Company suggests the Board consider providing hedging transition relief for modifications within the scope of the contract modifications. That is, for the modifications within the scope of the guidance, the Board would permit entities to disregard them for hedging purposes for the remainder of the hedge relationship. This principle also aligns with exceptions granted to hedging relationships assessed using a method that assumes perfect effectiveness subsequent to the inception of the hedging relationship.

The Company currently assesses the commercial loans under cash flow hedges for interest rate risk attributable to LIBOR fluctuations using the long haul method. This proposed provision (to ignore the out-of-the-money option in the subsequent effectiveness assessment) will significantly ease the operational burden for the Company to maintain the existing cash flow hedges. If the Company is required to reflect the modification in the measurement of the hedged item, significant effort will be required to configure systems and processes. Additionally, inclusion of out-of-the-money options in the measurement of the hedged item could potentially result in a failure of the hedge effectiveness. The Company anticipates that in practice existing cash flow hedges will be negatively impacted by the addition of out-of-the-money options in the absence of hedging relief. The Company believes that these existing hedges should be able to continue to qualify for hedge accounting for the hedges’ remaining life, without being required to modify the hedge, both at adoption and subsequently upon sunset. The out-of-the-money options are a cost efficient mechanism to prevent volatile market movement during transition and should be granted relief during the transition. Upon sunset, the mismatch should be ignored if they continue to be out of the money. The out-of-the-money options is a risk management tool leveraged in the bilateral contract negotiations with customers. It would be executed separately during the LIBOR transition from the corporate wide interest rate risk management practice. The economic essence of the hedging transaction is to ensure the minimum cash flow floor is protected. If this optionality is included in the subsequent measurement of the hedged item, the Company would face either less optimal regression result by recasting the hypothetical derivative or removing the commercial loans from the hedged item pool completely. Either outcome would be contradictory to the intent of the guidance to facilitate the smooth transition from the LIBOR.

The Company understands that modifications within the scope of the exposure draft are granted to a contract until the maturity of the contract. The Company is seeking the Board’s further guidance if out-of-the-money options added during the transition to financial assets already designated under a cash flow hedge, using the long haul method, can be excluded from the subsequent effectiveness assessment both during the relief period and into the remaining life of the existing cash flow hedge. The
Company agrees that new hedges entered into during the relief period, or post sunset, should reflect the modification made to the hedged item and out-of-the-money options should be measured for the purpose of effectiveness assessment.

In the event that the replacement rate option market is not fully developed during transition, the Company may be forced to add out-of-the-money fixed rate caps or floors to its existing financial assets and liabilities. Based on the same reasoning explained above, the Company suggests the Board consider granting life long relief to the fixed rate interest rate caps or floors with regard to the subsequent measurements of hedged items under existing cash flow hedges with quantitative effectiveness method elected. The fair value of out-of-the-money options or fixed rate caps or floors are minimal in the rising interest rate environment and reflect primarily timing value of these features. Exclusions from the subsequent quantitative measurement would not result in material changes in financial statements or any unintended consequences from the perspective of investors. We believe the significant cost savings from the operational perspective would outweigh the immaterial financial impact resulting from the relief.

The intent of the Company is to gain protection from the exposure to the worst interest rate scenario with the anticipated short-term market volatility during the transition period. The Company has no control over the long term interest rate curve. If the lower interest rate environment persists post sunset date, the inclusion of these floors in the regression analysis will negatively impact the regression results to the extent that the regression result may fall outside of the prescribed thresholds. The loss of hedge accounting post sunset due to the reasons outside of the Company’s control is punitive. Therefore, the Company requests the Board consider the lifetime exemption for the existing cash flow hedges impacted by the contract modification necessities for the reference rate reform.

Treatment of Basis Adjustments
We are generally in agreement with the Board on the proposed optional expedient for the change in the designated benchmark interest rate. We appreciate the fact that the Board made it optional for entities to apply the relief without de-designating the existing fair value hedges. With respect to the exposure draft (paragraph 848-40-25-5), an accounting policy election for basis adjustments attributable to changes in the fair value of the hedged item (due to a change in the designated benchmark interest rate), entities are required to apply the same method for the associated basis adjustments for similar hedges. The Company requests the Board allow the election at the individual hedge level in order to provide operational ease to entities impacted.

Capital One has designated multiple fair value hedges on its own debt instruments, and to a lesser extent, available-for-sale debt securities. These hedges have a variety of tenors and were designated using different interest rate benchmarks. Certain hedges were not modified post adoption of ASU 2017-12 and continued to apply the full contractual coupon method based on the current balance sheet interest rate sensitivities and management tolerance. For individual hedge relationships, the Company may prefer to treat the basis adjustments differently based on the overall risk management strategy and the circumstances at the time. The hedge-by-hedge election would not create inconsistent methods as both proposed treatments would result in amortization (explicit or implicit) of the basis adjustments over time. The Company therefore requests the Board consider changing the policy election to be at the hedge-by-hedge level to be consistent with the remaining optional relief.
Cross Currency Basis Transition Relief
The proposed guidance does not specifically address cross currency swaps and the basis quantifications. The cross currency basis represents the USD LIBOR and foreign currency IBOR mismatch. The fair value may be impacted materially due to the transition timing difference of interest rate indexes on which the currency pair is based. We therefore request the Board provide clarification guidance to provide relief and flexibility in dealing with the fair value change of the cross currency basis spread, potentially with the extension of the relief beyond sunset. We suggest the Board considering the relief similar to the relief granted to the basis adjustments attributable to changes in fair value of hedged item due to a change in the designated benchmark interest rate. That is, the cross currency basis fair value changes should either be amortized or locked in during transition. Other jurisdictions’ transition plan is out of the control of companies operating within the US territory. In the event there is a timing gap among multiple jurisdictions’ IBOR transition, the Company requests clarification on accounting for the fair value change of the cross currency basis, and the timing delay beyond sunset.

Disclosures
The Company appreciates the FASB reaching out to understand the cost and complexity associated with rate reform disclosure requirements. The Draft allows companies the flexibility necessary to navigate a complex transition, while being mindful of the costs associated. We believe that requiring prescribed quantitative disclosures related to the transition would negate these fundamental benefits provided. Furthermore, the SEC recently released public statements suggesting that companies should keep investors informed regarding transition progress and the anticipated impact, if material. As we continue through the transition journey, we plan to provide investors and users of our financial statements with timely necessary information to keep them informed.

Transition Date
Given that the transition will be a significant change for the industry, transition relief will be critical to allow companies to continue to manage their balance sheet risks and prevent reporting unintended financial statement volatility. Furthermore, as the timing and extent of the impacts from the transition remain largely unknown, we request the Board’s flexibility in the timing and nature of the standard’s transition relief provisions.

Sincerely,

/s/ Timothy Golden

Timothy Golden
Controller
Capital One Financial Corporation