Mr. Shayne Kuhaneck  
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File Reference No. 2019-770  
Financial Accounting Standards Board  
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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:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update (ASU), Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting, issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB’s effort to provide relief that would facilitate the market transition from the London Interbank Offered Rate (LIBOR) and other interbank offered rates (IBORs) to alternative reference interest rates. Without this relief, accounting for changes to contracts stemming from what is known as reference rate reform would result in less decision-useful information for users, would be costly and burdensome to apply, and could result in reporting that is inconsistent with an entity’s business strategy and risk management objectives.

We commend the Board for addressing stakeholders’ concerns about the potential accounting issues stemming from reference rate reform in a timely manner. It is our understanding that many constituents are waiting for the issuance of final guidance to begin modifying contracts that will be affected by reference rate reform. Therefore, we support the Board’s continued prioritization of this project. We also support the Board’s stated intention to monitor market developments related to reference rate reform and consider the need for potential amendments to any final guidance issued. Given the uncertainty surrounding the transition from existing reference rates, we believe the Board should be ready to address any unforeseen transition issues in a manner that is both timely and consistent with the overall objectives of the proposed relief.

Our responses to the questions in the proposal are included in the Appendix.

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

Very truly yours,

Ernst & Young LLP
Appendix: Responses to Questions for Respondents included in the FASB’s proposal

General

**Question 1 – Costs and Complexities:** Are the amendments in this proposed Update operable and auditable? If not, which proposed amendment(s) pose operability or auditability issues and why?

While we agree that the proposed amendments would generally be operable and auditable, we believe certain aspects of the proposal need to be clarified, as discussed in our responses to questions 3, 5 and 6 below.

We have identified one aspect of the proposal that may be challenging from an operational and audit perspective. Proposed paragraph 848-20-15-5(b) states that a spread adjustment for the difference between an existing and replacement reference rate would be considered a change in terms that is related to the replacement of a reference rate. However, proposed paragraph 848-20-15-6(d) goes on to clarify that any such spread adjustment cannot include any change in the counterparty’s credit spread. Conceptually, we agree that modifying the spread on a referenced index for changes in a counterparty’s credit risk after the issuance of the contact does not represent a change that is related to the replacement of the reference rate. However, we are concerned that it may be difficult for entities to validate that the spread adjustments in modified contracts completely exclude any consideration of changes in the counterparty’s credit spread and, therefore, are eligible for the proposed relief.

For instance, modifications to contracts related to cash instruments may be the result of negotiations between the counterparties, thereby making it difficult to obtain observable evidence to validate that the spread adjustment relates solely to the difference between the previous reference rate and the new reference rate. Obtaining this evidence could be especially burdensome for financial institutions and other entities that have a large volume of contracts that may be modified on different dates.

We therefore recommend that the Board include an expedient in any final guidance that would indicate that, absent evidence to the contrary, spread adjustments are presumed to relate to differences between the existing and replacement reference rates.

**Question 2 – Additional Issues:** Are there additional accounting issues or optional expedients related to reference rate reform that the Board should consider? Please be as specific as possible and explain why those issues require consideration.

We recommend that the FASB continue to monitor developments regarding the potential tax consequences of the transition to alternative reference rates, including whether a modification to a debt or derivative instrument will be treated as a taxable event. We understand that the US Treasury Department is considering this issue, and we believe that the FASB should be ready to consider whether any relief from income tax accounting requirements is needed to align with any decisions reached by the Treasury Department regarding tax consequences of reference rate reform.
We discuss other additional expedients for the Board’s consideration in our response to questions 5 and 6 below.

**Contract modifications**

**Question 3 – Expedients:** Do you agree with the proposed expedients for the accounting for contract modifications? If not, please explain which proposed amendment(s) you disagree with and why.

We agree with the proposed expedients for the accounting for contract modifications but believe additional guidance or clarification is needed for the following items.

**Changes to terms that are related and unrelated to the replacement of a reference rate**

**Payment frequency**

Proposed paragraph 848-20-15-5(c) refers to “a change from a forward-looking term rate to an overnight rate or a compound overnight rate in arrears with the same payment frequency” as an example of a change in terms that would be related to the replacement of a reference rate. We find the inclusion of the phrase “with the same payment frequency” to be confusing because it could be interpreted to imply that a modification to the payment frequency of a contract represents a change in terms that would be deemed unrelated to the replacement of a reference rate. However, this would seem inconsistent with the fact that changes in payment dates are explicitly included in this same paragraph as a change that would be deemed related to the replacement of a reference rate. Accordingly, we recommend that the Board delete the phrase “with the same payment frequency” from the example or clarify why it included this phrase.

**Changing from a variable rate to a fixed rate**

Paragraph BC24 of the Background Information and Basis for Conclusions in the proposal indicates that the optional expedients for contract modifications would generally not apply to a change from a variable rate to a fixed rate because the Board believes that a negotiated fixed rate could include a spread component related to a credit decision that is separate from reference rate reform. However, paragraph BC24 goes on to state that the Board did not intend to prohibit an entity from applying the proposed expedients for contract modifications if the fixed rate is predetermined on the basis of the most recent reset of a variable rate affected by reference rate reform. In this case, the discussion in paragraph BC24 is not clear about whether this fixed rate would continue to include the credit spread that existed at the issuance of the original contract.

If the Board intends to allow entities to apply the proposed expedients in certain situations where a reference interest rate is changed to a fixed rate, we believe it should further clarify this guidance and include it in the Accounting Standards Codification rather than just the Basis for Conclusions.

In this case, the guidance in proposed paragraph 848-20-15-2, which indicates that modified terms would “directly replace, or have the potential to replace, a reference rate within the scope of paragraph 848-10-15-3 with another interest rate index” would likely need to be amended, since the underlined language would not seem to allow for changes to a fixed rate in any circumstances.
Changes to collateral arrangements, debt covenants and the priority of an obligation

Paragraph BC26 of the Basis for Conclusions indicates that changes to collateral arrangements, debt covenants and the priority of an obligation would all be driven by factors that are unrelated to reference rate reform. Paragraph BC26 also notes that all of these changes would be considered modifications to terms that could have a potential effect on future cash flows in certain circumstances. Based on proposed paragraph 848-20-15-3, it would appear that any contract in which one or more of these terms are modified would not qualify for the relief that would be provided in 848-20.

If this is the Board’s intent, we believe this should be made clear in the Codification rather than just in the Basis for Conclusions. This could be done by including these modifications as examples of changes to terms that are unrelated to the replacement of a reference rate in paragraph 848-20-15-6.

Addition of an at-the-money cap or floor

The proposal is clear that the addition of an out-of-the-money interest rate cap or floor to a contract would be deemed a change to terms that is related to the replacement of the reference rate. The proposal is also clear that the addition of an in-the-money cap or floor would be considered a change to terms that is unrelated to the replacement of the reference rate. The Board’s rationale in paragraph BC29 of the Basis for Conclusions for this distinction seems to be that the addition of an in-the-money option would immediately transfer intrinsic value, while the addition of an out-of-the-money option (which would only transfer time value) provides protection against uncertain future volatility.

Based on this view, the lack of any intrinsic value associated with the addition of an at-the-money cap or floor could be viewed to support a determination that this would represent a change in terms that is considered to be related the replacement of the reference rate (consistent with an out-of-the-money cap or floor). However, we believe that any final guidance should specifically address whether the addition of an at-the-money cap or floor would be considered a change to terms that is deemed to be related or unrelated to the replacement of the reference rate.

Leases

We believe that paragraph 848-20-35-10 in the proposal should reference “discount rates” instead of “the incremental borrowing rate,” given that the guidance would apply to both lessees and lessors. When recognizing and measuring lease-related assets and liabilities, lessees generally use\(^1\) their incremental borrowing rate, while lessors use the rate implicit in the lease. In addition, to further clarify that the guidance applies to both lessees and lessors, the Board should include guidance on the treatment of variable-lease payments by lessors that is consistent with the proposed guidance for lessees in paragraph 848-20-35-10 through 12.

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\(^1\) Certain lessees (e.g., lessees with contracts with their parents/lessors) may also use the rate implicit in the lease to recognize lease-related assets and liabilities.
Finally, we believe the proposed guidance in paragraph 848-20-35-10 through 12 should apply to ASC 840, in addition to ASC 842, particularly given the FASB’s current proposal to defer the effective date of ASC 842 for certain non-public business entities (non-PBEs) because they may continue to apply ASC 840 in the period when reference rates are replaced.

**Question 4 – Election Level:** Do you agree that the optional expedients for contract modifications should be applied at the relevant Topic, Subtopic, or Industry Subtopic level? If not, what alternative do you suggest and why?

We appreciate the Board’s rationale in paragraph BC41 of the Basis for Conclusions for proposing that entities apply the optional expedients for contract modifications at the relevant topic, subtopic or industry subtopic level and its concern that applying the proposed relief on a contract-by-contract basis could result in an entity selectively applying the expedients to affect earnings. However, because it is unclear to us whether application at this level would be consistent with how entities are expected manage their contract modifications, we suggest that the FASB carefully consider constituent feedback on this question.

For instance, from a commercial perspective, some entities may view contract modifications differently by class of assets (e.g., commercial loans, residential mortgages, auto loans). Depending on constituent feedback, the Board may want to consider whether the contract modification relief could be applied at a level below the topic, subtopic or industry subtopic level without compromising the Board’s desire to limit the potential for earnings management.

**Hedge accounting**

**Question 5 – Change in Critical Terms:** Do you agree with the proposed exceptions to the requirement in Topic 815 to desiginate a hedging relationship for a change in critical terms of the hedging relationship? If not, please explain which proposed amendment(s) you disagree with and why.

We agree with the proposed exceptions to the requirement in ASC 815 to desiginate a hedging relationship for a change in critical terms of the relationship. However, we believe additional guidance or clarification is needed for the following items.

**Change to a counterparty**

Paragraph 848-20-15-6(l) in the proposal indicates that changes to the counterparty in an agreement would be considered a change to terms that is unrelated to the replacement of the reference rate. Therefore, the proposal would seem to indicate that if, in addition to modifications made to terms related to the replacement of the reference rate, the counterparty to a hedging instrument is changed, the contract would not qualify for the proposed relief related to hedge accounting since it would not meet the requirements in paragraphs 848-20-15-2 through 15-3, as required by paragraph 848-30-25-5. As a result, a change to the counterparty in the hedging instrument would result in a desigination of the hedging relationship, even though all changes to the critical terms of the hedging instrument were related to the replacement of the reference rate.
If this is the Board’s intention, we question this outcome because it would be inconsistent with the existing guidance in ASC 815 under which a change in the counterparty of a hedging derivative would not, in and of itself, be considered a change in a critical term of the hedging relationship that requires redesignation. Because changing the counterparty to a hedging derivative would not trigger a redesignation under existing US GAAP, it seems counterintuitive that such a change could trigger a redesignation if all the other changes to the hedging instrument were related to reference rate reform.

Similarly, it is our view that changes to a counterparty should not disqualify an entity from applying the proposed relief in 848-20 to a modified contract where all other changes to terms are deemed related to reference rate reform. For instance, under existing US GAAP, solely changing the counterparty in a lending arrangement (e.g., where a loan is sold from one bank to another) does not trigger, in and of itself, the need for the borrower to assess whether the loan has been modified or extinguished. Therefore, we recommend that the Board delete the proposed example in paragraph 848-20-15-6(l).

Changes to collateral arrangements

As discussed in our response to question 3 above, paragraph BC26 of the Basis for Conclusions indicates that changes to collateral arrangements are unrelated to reference rate reform and are considered modifications to terms that could have a potential effect on future cash flows in certain circumstances. Therefore, the proposal would seem to indicate that if, in addition to modifications made to terms related to the replacement of the reference rate, a collateral arrangement that covers a hedging derivative is changed, the corresponding hedging relationship would not qualify for the proposed relief related to hedge accounting since it would not meet the requirements in paragraphs 848-20-15-2 through 15-3, as required by paragraph 848-30-25-5.

Under existing US GAAP, collateral is generally viewed as a separate unit of account from the hedging derivatives it secures, and, therefore, changes to collateral arrangements do not necessarily require a redesignation of the related hedging relationships unless a compensating change is also made to a critical term of the hedging derivative instrument itself. As a result, we believe the Board should reconsider identifying changes to collateral arrangements as a change in terms that would prohibit an entity from applying the proposed expedients in 848-30-25.

However, if the Board decides to move forward with the proposed approach on changes to collateral arrangements, we recommend that any final guidance clarify that changes to the reference interest rate used to determine interest paid on cash collateral held would not be considered a change in terms that is unrelated to reference rate reform. In our view, a change to the interest rate paid on collateral held is not the result of a new underwriting or credit decision as discussed in paragraph BC26. Such a clarification would also be consistent with the proposed guidance in paragraph 848-30-25-6 regarding contract price alignment for centrally cleared derivatives.
Question 6 – Fair Value Hedges: Do you agree with the proposed optional expedients for fair value hedge accounting? If not, please explain which proposed amendment(s) you disagree with and why.

We generally agree with the proposed optional expedients for fair value hedge accounting but believe additional clarification is needed for fair value hedges of foreign exchange risk. With respect to changing the critical terms in a fair value hedge, the proposed guidance in paragraph 848-30-25-3(b) refers to changing the hedged risk of a hedged item. However, in a fair value hedge of only foreign exchange exposure, replacing the reference interest rate in the hedged item would not seem to result in a change to the hedged risk.

For example, consider a USD functional currency entity that has issued variable-rate debt denominated in GBP that currently references GBP LIBOR as the reference interest rate. Also, assume that the entity has designated a float-for-floating USD/GBP cross-currency swap as a fair value hedge of the debt (effectively converting it into USD variable-rate debt). As part of reference rate reform, if the entity were to modify the terms of the debt to change the reference interest rate from GBP LIBOR to the Sterling Overnight Interbank Average Rate (SONIA), the hedged risk (i.e., changes in the fair value of the GBP-denominated debt due to changes in the USD/GBP foreign exchange rate) would not technically change. As the proposed guidance is currently written, it is not clear to us that such a modification would be captured in the scope of proposed relief for fair value hedges.

While we understand there may be differing views on whether such a modification would be considered a change to the critical terms of this hedging relationship requiring transition relief, we believe that any final guidance should be clear that dedesignation of this fair value hedging relationship would not be required when a change to the terms of the hedged item is related to reference rate reform. Therefore, we recommend that the Board clarify that changes to the critical terms of a hedged item (that are related to the replacement of a reference rate) in a fair value hedge of only foreign exchange risk would be eligible for the proposed relief related to dedesignation of the hedging relationship.

Question 7 – Cash Flow Hedges: Do you agree with the proposed optional expedients for cash flow hedge accounting? If not, please explain which proposed amendment(s) you disagree with and why.

We agree with the proposed optional expedients for cash flow hedge accounting. However, we note what appears to be an incorrect reference in paragraph 848-50-35-17(b) of the proposal indicating that an entity would discontinue the use the optional expedients for assessing cash flow hedge effectiveness if “the guidance in this Topic is superseded (see paragraph 848-10-65-1(d)).” We do not see paragraph 848-10-65-1(d) in the proposal.

Question 8 – Election Level: Do you agree that the proposed exceptions and optional expedients related to hedge accounting should be applied on an individual hedging relationship basis? If not, please explain why.

Yes, we agree that the proposed exceptions and optional expedients related to hedge accounting should be applied on an individual hedging relationship basis.
Disclosures

**Question 9 – Contracts or Holdings:** What quantitative and qualitative disclosures should be provided to help users understand a reporting entity’s current contracts or holdings (as of the reporting date) that are affected by reference rate reform? For financial statement preparers, what costs would be incurred in providing these disclosures? For financial statement users, what alternative sources of information would be used if a reporting entity does not provide any quantitative and qualitative disclosures? What costs would be incurred to obtain quantitative and qualitative information to better understand a reporting entity’s exposure to reference rate reform? Should the quantitative and qualitative disclosures, if any, have a termination date after December 31, 2022? If not, when should such disclosures expire and why?

**Question 10 – Hedge Accounting:** What quantitative and qualitative disclosures should be provided to help users understand the financial reporting effects of expedients elected by a reporting entity? For financial statement preparers, what costs would be incurred in providing these disclosures? For financial statement users, what costs would be incurred if a reporting entity does not provide any quantitative and qualitative disclosures to help financial statement users understand the financial reporting effects of any hedge accounting expedients elected?

It isn’t clear to us how users of the financial statements would benefit from disclosures related to the application of the proposed transition relief. For instance, we are not sure how investors or other users of financial statements would use the information about the categories of contracts to which an entity has applied the proposed relief. Similarly, it is also unclear how financial statement users would use information about the percentage or amount of eligible contracts or hedging relationships for which the proposed relief could have been elected but was not (including the reason for this decision).

In addition, we believe requiring quantitative disclosures to help users understand the financial reporting effects of the expedients elected would be burdensome and costly for preparers and would seem to diminish the benefit of the proposed relief.

Accounting policy elections made in accordance with the proposed relief would be disclosed in accordance with existing US GAAP requirements as needed.

**Question 11 – Transition:** Do the proposed transition disclosure requirements provide decision-useful information? If not, what would you recommend and why?

In our view, the proposed transition disclosures in paragraph 848-10-65-1(c) would be of limited use because the nature and reasons for electing the proposed relief would likely be known to investors, and many entities would have already disclosed how they managed the transition away from LIBOR and other existing reference rates.
Transition and termination date

**Question 12 – Transition:** Do you agree that the proposed optional expedients should be applied on a prospective basis upon election? If not, what alternative do you suggest and why?

We agree that the proposed optional expedients should be applied prospectively upon adoption. It is our understanding that paragraph 848-50-35-2 of the proposal would address the interaction of this transition approach with the general requirement in ASC 815 that hedge effectiveness be subsequently assessed both prospectively and retrospectively by indicating that an entity need not perform a retrospective assessment in the period that the relief is initially applied.

We do not, however, agree with the proposed guidance in paragraph 848-10-65-1(b) that would prohibit entities from applying the transition relief until they have adopted the amendments in ASU 2017-12. While we appreciate the considerations noted by the Board in paragraph BC 87 of the Basis for Conclusions, we believe this proposed requirement could significantly hinder non-PBEs that have not adopted ASU 2017-12 from actively managing their transition away from LIBOR and other IBORs in a timely manner and would seem to be at odds with the Board’s recent proposal to extend the effective date of ASU 2017-12 for non-PBEs.

In addition, the proposed limitation could potentially raise questions about how these entities would apply hedge accounting for existing cash flow hedging relationships even when no modifications have been made to the hedging instrument or hedged item, since these entities could not apply the proposed expedient in paragraph 848-50-25-2.

**Question 13 – Termination Date:** Do you agree that the proposed amendments should not apply to contract modifications made and hedging relationships entered into or evaluated after December 31, 2022? If not, when should the proposed amendments expire and why?

While we understand the Board’s desire to have a definitive end date to its proposed transition relief, we believe the proposed amendment indicating that relief could not be applied to contract modifications that occur after 31 December 2022 or hedging relationships entered into or evaluated after that date seems to have been determined based primarily on the expected timing of the discontinuation of LIBOR. In our view, the Board should consider transitions from other IBORs (e.g., EURIBOR, TIBOR, CDOR) that may be on a different timeline when determining the inclusion of any sunset provision in any final guidance.

We acknowledge the challenge this may pose given the uncertainty over the expected timing of the discontinuation of certain other IBORs. If the Board is concerned about extending the application period for relief related to the transition away from LIBOR to consider the timing of other IBORs’ transitions, one approach could be to consider providing different sunset provisions for different reference rate transitions.

For example, the Board could include a sunset provision for the transition away from LIBOR in any final guidance initially issued and subsequently add additional sunset provisions for other IBOR transitions as their expected timelines become clear. This approach would be consistent with the Board’s acknowledgment that it will need to continue to monitor market developments and consider whether changes to any final guidance may be warranted. Paragraph 848-10-15-4 in the proposal would provide guidance on when an entity may begin to apply the proposed relief to reference rates other than LIBOR.