

FASB Emerging Issues Task Force

Issue No. 13-A

Title: Inclusion of the Fed Funds Effective Swap Rate as a Benchmark Interest Rate for Hedge Accounting Purposes

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Background

1. Topic 815, Derivatives and Hedging, provides guidance on the risks that are permitted to be hedged in a fair value or cash flow hedge. Among those risks for financial assets and financial liabilities is the risk of changes in a hedged item's fair value or a hedged transaction's cash flows attributable to changes in the designated benchmark interest rate (referred to as benchmark interest rate risk).

2. The Master Glossary of the Codification defines a benchmark interest rate as:

A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions.

In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a

*** The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

benchmark. In other markets, the benchmark interest rate may be an interbank offered rate.

3. Further, paragraph 815-20-25-6A states:

In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the London Interbank Offered Rate (LIBOR) swap rate¹ are considered to be benchmark interest rates. In each financial market, only the one or two most widely used and quoted rates that meet these criteria may be considered benchmark interest rates. The Fed Funds rate, the Prime rate, the Federal National Mortgage Association (FNMA or Fannie Mae) Par Mortgage rate, and the Securities Industry and Financial Markets Association Municipal Swap Index (formerly called the Bond Market Association index) shall not be used as the benchmark interest rate in the United States.

4. For simplicity, the stated interest rate in a financial asset or liability can be characterized as containing two components, a risk-free rate and a credit spread. In permitting the hedge of the benchmark interest rate risk in Topic 815, the FASB was providing a practical means to designate the risk of changes in the hedged item attributable to changes in the risk-free component of the interest rate (that is, benchmark interest rate risk, which, in theory, is the risk-free component) in isolation, without requiring that an entity also hedge changes in the spread (which is deemed to reflect credit risk) above the benchmark interest component. As described in the basis for conclusions to FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, the FASB decided that, in the U.S., the interest rate on direct Treasury obligations of the U.S. government provides the best measure of the risk-free component for hedge accounting purposes. Thus, the FASB considered defining benchmark interest rate risk based only on U.S. Treasury rates (UST) in the U.S.

5. However, the FASB decided to make an exception and extend the definition of benchmark interest rate to also include interest rate swap rates based on LIBOR given its understanding that:

¹ The Master Glossary of the Codification defines LIBOR Swap Rate as the fixed rate on a single-currency, constant-notional interest rate swap that has its variable-rate leg referenced to the London Interbank Offered Rate (LIBOR) with no additional spread over LIBOR 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, equate to the present value of the variable cash flows.

- a. LIBOR-based interest rate swaps are the most commonly used hedging instruments in the U.S. financial markets in hedges of interest rate risk.
- b. There are technical factors (such as supply and demand) that may affect the rates on direct obligations of any single issuer, even the U.S. government.
- c. Financial markets consider LIBOR rates as inherently liquid, stable, and a reliable indicator of interest rates and, if the rate for hedging interest rate risk was limited to U.S. Treasury rates, many common hedging relationships using LIBOR-based swaps might not qualify for hedge accounting.

6. During its deliberations leading up to Statement 138, the FASB considered whether other rates in the U.S. financial markets, such as the commercial paper rate and the Fed Funds Rate, should be included in the definition of benchmark interest rate. The FASB rejected the commercial paper rate and the Fed Funds Rate as benchmark rates in the U.S. and decided that allowing more than two benchmark rates (that is, UST and LIBOR) to define interest rate risk was unnecessary and would make the resulting financial statements more difficult to understand. Therefore, currently other such indexes may not be used as the benchmark interest rate in the U.S.

7. The Fed Funds rate is the interest rate at which depository institutions (for example, banks) actively trade balances held at the Federal Reserve with each other, usually overnight. Institutions with surplus balances in their accounts at the Federal Reserve Banks lend those balances to institutions in need of additional reserves in their accounts to meet reserve requirements.² The interest rate that the borrowing bank pays to the lending bank to borrow the funds is negotiated between the two banks, and the weighted average of this rate across all such transactions on any given day is the daily Fed Funds Effective Rate (FFE).³ The related OIS ("Overnight Index Swap Rate" or "Fed Funds Effective Swap Rate") is the fixed rate⁴ swapped in

² Fed Funds – Fedpoints, Federal Reserve Bank of New York (<http://www.newyorkfed.org/aboutthefed/fedpoint/fed15.html>).

³ The Federal Open Market Committee sets a target level for the Fed Funds Rate, which is its primary tool for implementing monetary policy. However, that published target rate is not the rate that establishes the FFE, which is based on actual transactions between banks (that is, the FFE is determined by market participants and not set by the Federal Reserve).

⁴ The OIS 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 floating FFE cash flows. Thus, in the U.S., the relationship between FFE and OIS is the same as the relationship between LIBOR and the LIBOR swap rate (as defined in the Master Glossary).

exchange for a floating overnight rate, which is the FFE.⁵ The terms "Fed Funds" and "Fed Funds Rate" are used interchangeably in this memorandum and encompass both the FFE and the Fed Funds Effective Swap Rate ("OIS").

8. As a result of the 2008 financial crisis, the FASB staff understands that the demand for hedging products incorporating the Fed Funds rate has increased significantly. That demand has been driven by an increased focus by banks on their sources of funding, widening of spreads between LIBOR and OIS, and new regulatory measures to curb systemic risks (such as increased collateralization of derivatives).

9. Prior to the 2008 financial crisis, LIBOR and OIS, two major funding rates for the banks, were highly correlated and traded closely to each other with spreads between these rates typically being about 5 to 10 basis points. However, during the financial crisis when markets were particularly volatile (and ever since that time), spreads between those rates widened exceeding 350 basis points (LIBOR above OIS) at one point. Over the last year the LIBOR-OIS spread fluctuated between 15 and 50 basis points due to a variety of factors including the European financial crisis. The spread between LIBOR and OIS is viewed as a measure of the credit and liquidity risk differences between LIBOR and OIS. While both LIBOR and OIS are indicative of high-quality borrowing rates, the extent of the credit risk associated with OIS rates is very low since OIS involves an overnight transfer of funds. As a result of the widened (and sometimes volatile) spread between LIBOR and OIS, the staff understands that the market for derivative products based on the Fed Funds Rate has grown. Some interest rate risk managers have started looking for a shorter term rate with reset dates that occur on an overnight basis that is less sensitive than the swaps spread volatility associated with LIBOR. The liquidity in Fed Funds-based derivatives also has increased since the FASB made its decision not to include the Fed Funds Rate as a benchmark interest rate more than a decade ago, with most of the increase occurring in the last few years. Fed Funds-based derivatives, such as Fed Funds Rate/LIBOR basis swaps, are now traded in more significant volumes and tenors have increased in the past several years from being relatively short (2-3 years) to being up to 30 years.

⁵ In a plain-vanilla Fed Funds based swap, the counterparties agree to exchange the difference between interest accrued at the derived fixed rate and interest accrued at the floating index rate, which replicates the interest that would be earned from rolling over a daily loan at the overnight Fed Funds Rate.

10. The increased prevalence of OIS in the marketplace can also be seen in derivatives valuation. As background, the value of a derivative is directly affected by the contractual terms of the derivative that directly affect the cash flows exchanged in the transaction. Those cash flows are generally measured as the difference between a fixed rate and a variable rate, such as LIBOR interest rates. To calculate the value of the derivative, those cash flows are discounted at a rate that reflects the time value of money. As a result, both the contractual terms of the derivative and the discount rate affect the value of the derivative.

11. Before 2008, derivatives counterparties generally used LIBOR as the discount rate in valuing derivatives, regardless of the collateral arrangement or the funding dynamics. The volume of collateralized and partially-collateralized derivatives has grown as a result of the 2008 financial crisis, as have legislative requirements to transact trades through clearing houses and regulatory proposals that may lead to increased margin requirements. As the volume of collateralized derivatives grew, so did the need for an answer to the question about whether the return on the collateral that is factored into the determination of the discount rate for the valuation of derivatives should continue to be based on LIBOR. The response from some counterparties is that their derivatives should be valued based on how they fund the derivative instrument's cash flows.

12. Previously, the return on collateral was generally based on three-month LIBOR; however, in the past few years, the U.S. market has moved to an overnight rate, which is generally based on the Fed Funds Rate, in recognition of the fact that collateral on derivatives is recomputed daily and thus available only overnight. Since the OIS rate is deemed the funding rate when collateral agreements require that interest owed on collateral received be based on the OIS rate, some leading clearing houses and other derivative counterparties now use the OIS rate, instead of LIBOR, to compute margin requirements.

13. As a result, instead of discounting the future cash flows of derivatives using LIBOR, practice is evolving such that some derivative counterparties believe that the appropriate discount rate to use in the valuation of collateralized derivatives should be based on OIS because that rate

reflects the lower cost of financing of a collateralized instrument. This has caused derivative counterparties to be more exposed to overnight rates even on derivatives whose cash flows are based on LIBOR resets. That is, because of the widened spreads between LIBOR and OIS, if the fair value of collateralized derivatives is measured by discounting the instruments' LIBOR-based cash flows at OIS, in some cases it may result in significantly different valuations than discounting with LIBOR, which may affect the measurement of ineffectiveness being reported for certain hedges of interest rate risk as explained further below under View A. On the basis of the discussions above, some derivative counterparties believe that OIS should be permitted as a benchmark interest rate in the U.S. for hedge accounting purposes.

Accounting Issue and Alternatives

Whether the Fed Funds Effective Swap Rate should be included as a U.S. benchmark interest rate for hedge accounting purposes.

View A: Yes. Including the Fed Funds Effective Swap Rate as an acceptable U.S. benchmark interest rate in combination with UST and LIBOR will provide risk managers with a better spectrum of interest rate resets to utilize as the designated benchmark interest rate risk component, which serves as a proxy for the theoretical risk-free rate under the hedge accounting guidance in Topic 815.

14. Proponents of View A believe that changes in the market and the growing pervasiveness of exposure to the Fed Funds Rate make it imperative that the hedging literature include the Fed Funds Rate as a benchmark interest rate in the U.S.

15. Proponents of View A note that the Fed Funds Rate is the most liquid and transparent overnight rate in the U.S. It is available daily and is the weighted average of Fed Funds transactions between depository institutions. Being a rate negotiated between depository institutions on excess funds at the Federal Reserve Banks, it generally falls within the spectrum of risk between UST and LIBOR. Proponents of View A believe that when the Board decided to focus on UST and LIBOR as the only acceptable benchmark interest rates in Statement 138, the predominance of Fed Funds transactions was not as great as it is today and UST and LIBOR

covered a significant portion of interest rate risks. However, as a result of the 2008 financial crisis, U.S. legislation that requires greater clearing of derivatives through exchanges or clearinghouses (which must be collateralized), and the greater (and sometimes volatile) spread between LIBOR and OIS, proponents of View A believe that the market now also needs the Fed Funds Rate to be an acceptable benchmark hedging proxy for the risk free rate.

16. Proponents of View A also believe that the FASB meant to incorporate some flexibility into the guidance to allow addition or subtraction of benchmark interest rates if circumstances change. In paragraph 19 of the Background Information and Basis for Conclusions section of Statement 138, it is stated that:

The Board determined that any definition of the benchmark interest rate that may be hedged should be flexible enough to withstand potential future developments in financial markets. For example, the Board decided that the current definition would result in the ability to replace the LIBOR swap rate with a more relevant benchmark interest rate should changes in the financial markets render the use of LIBOR swap rates obsolete.

17. With respect to the FASB's original comment in paragraph 17 of the Basis for Conclusions to Statement 138 that having more than two benchmark interest rates in the U.S. would make the financial statements more difficult to understand, proponents of View A disagree. Given the greater sophistication and understanding of derivatives and risk, and the expanded disclosures now required under Topic 815 as a result of issuance of FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, those proponents believe that providing hedge accounting for overnight interest rate risks that are appropriately designated will make the financial statements more appropriate and easier to understand as it will better reflect the risk management activities of the enterprise. In addition, proponents of View A believe that the Fed Funds Rate has become the predominant interest rate quoted in the U.S. market for collateral covering derivative exposures and that allowing use of the Fed Funds Rate as an additional benchmark interest rate would more appropriately reflect interest rate risk hedging strategies.

18. Proponents of View A note that IFRS does not appear to be prescriptive as to which indexes may be used as the benchmark interest rate and, accordingly, believe that Topic 815 also should

not be prescriptive as to the appropriate benchmark interest rate in the U.S. and that the guidance should be consistent for selection of benchmarks internationally and domestically. However, given the emerging nature of the issue, proponents of View A believe that the Task Force should only focus on the current practice issue of including an overnight benchmark interest rate for interest rate hedging; leaving the broader question of whether it is appropriate for the Board to prescribe benchmark interest rates to the FASB Hedge Accounting Project.

19. Proponents of View A are also concerned about the effect on a fair value hedge of interest rate risk if the Fed Funds Rate is not allowed to be an acceptable benchmark proxy for the risk free rate. Specifically, proponents of View A note that fair value interest rate hedging in the U.S. is almost exclusively LIBOR-based since LIBOR is a designated benchmark for interest rate hedge accounting. Entities that use LIBOR-based fixed-to-floating swaps as the hedging instrument in a fair value hedge of LIBOR as a benchmark interest rate risk will experience incremental ineffectiveness in the hedging relationship when Fed Funds discounting is applied to calculate the fair value of that hedging instrument.

20. Specifically, paragraph 815-25-35-1 requires that the carrying amount of the hedged item in a fair value hedge has to be adjusted for its fair value changes *attributable to the hedged risk* and that the hedged risk has to be a benchmark interest rate (currently LIBOR or UST) and cannot be the Fed Funds Rate. The method used to estimate the changes in value of the hedged item (for example, a bond) attributable to changes in LIBOR (that is, the benchmark interest rate risk being hedged) necessarily will utilize a discount rate that fluctuates from period to period based on changes in LIBOR because that is the hedged risk.⁶ The effectiveness of a hedging relationship is determined by comparing the change in the fair value of the hedging instrument with the change in the value of the hedged item that is attributable to the risk being hedged. The use of different discount rates, that is, use of the Fed Funds Rate to value the derivative (the hedging instrument) versus a method that incorporates LIBOR to measure the hedged item, and different adjustments to those discount rates each period, creates incremental accounting

⁶ Although Topic 815 does not prescribe any specific method for an entity to calculate changes in fair value attributable to the benchmark interest rate, two methodologies that may be used by an entity to estimate the changes in value of the hedged item attributable to the interest rate risk being hedged are illustrated in paragraphs 815-25-55-55 and 815-25-55-72 through 55-77.

ineffectiveness in the fair value hedging relationship, which may be significant in some cases.⁷ Proponents of View A believe that if the Fed Funds Rate were permissible as a benchmark interest rate, hedgers would utilize Fed Funds products for fair value hedging strategies, thereby eliminating this incremental source of ineffectiveness that results from the current limitation on permissible benchmarks.

View B: No. The benchmark interest rate available in the U.S. market should be limited to the two rates, UST and LIBOR as prescribed in Topic 815 after due deliberations.

21. Proponents of View B note that the benchmark interest rate is defined in Topic 815 to be a rate that is widely recognized, quoted in an active market, and indicative of the overall level of interest rates attributable to high-credit-quality obligors in the market. While they agree that the Fed Funds Rate is referenced for loans of excess reserve balances at Federal Reserve Banks between depository institutions and that it is also a referenced interest rate for many cash collateral receivables or payables related to derivative transactions, proponents of View B do not believe that it is necessarily a widely recognized rate for broader corporate lending transactions in the financial markets within the U.S.

22. Proponents of View B also note that the FASB, during its deliberations on Statement 138, decided the interest rate on direct Treasury obligations would provide the best measure of a risk-free rate, and only provided an exception for LIBOR mainly because of its prevalence in the market as a hedging instrument for interest rate risk. Proponents of View B believe that while the Fed Funds Rate may have become more liquid in the market, its use as a hedging instrument for interest rate risk is not as prevalent as LIBOR to be offered its own exception. Proponents of View B believe that LIBOR has not retreated from being the most widely used and liquid benchmark for rates for tenors of one month or more, nor has it been significantly challenged as the primary benchmark in most floating rate loans or notes. As such, LIBOR continues to be the critical benchmark rate necessary for interest rate hedging.

⁷ In contrast to a "long haul" method for assessing effectiveness as described above, the "shortcut" method is based on an assumption of no ineffectiveness. Accordingly, no ineffectiveness will result for hedges that qualify for the shortcut method, since the hedged item is simply adjusted for the change in value of the interest rate swap each period (that is, no separate calculation related to the hedged item is performed). However, there are stringent requirements to qualify and the "shortcut" method can only be applied to hedges of benchmark interest rates.

23. Proponents of View B further note that paragraph 815-20-25-6A specifically prohibits the Fed Funds Rate to be a benchmark interest rate and that the FASB, during its deliberations leading up to Statement 138, determined that allowing more than two benchmark rates (that is, UST and LIBOR) to define interest rate risk was unnecessary and would make the resulting financial statements more difficult to understand. Proponents of View B share the same concerns in support of not allowing the Fed Funds Rate to be a benchmark interest rate.

24. Proponents of View B also note that the Board will be redeliberating further refinements to the hedging model within the FASB Project, Accounting for Financial Instruments: Hedging. Although the scope of the redeliberations is still to be determined, View B proponents recommend that the benchmark interest rate be considered in those redeliberations, if the Board considers it appropriate. That is, View B proponents believe that the ability to hedge a benchmark interest rate is a significant matter of concern and the scope of such amendments should not be narrowly discussed within the confines of the EITF.

Recurring Disclosures

25. The FASB staff does not believe additional recurring disclosures should be required by this Issue. Section 815-10-50 requires extensive quantitative and qualitative disclosures about derivatives and hedging activities primarily based on underlying risk and accounting designation; however, it does not require that an entity specifically disclose the actual interest rate benchmark (for example, UST or LIBOR) that is hedged. As part of this limited-scope EITF Issue, the FASB staff does not believe it is necessary to revisit the Board's previous conclusions as to the granularity of disclosure in this regard.

Transition

26. The application of hedge accounting is optional. To qualify for hedge accounting, Topic 815 requires formal designation and documentation of the hedging relationship before hedge accounting may be applied. Since retrospective application would be contrary to the contemporaneous hedge documentation requirements, the FASB staff believes that this Issue

only can be applied on a prospective basis for qualifying new or redesignated hedging relationships entered into on or after the date of adoption.

Transition Disclosures

27. The staff does not believe transition disclosures should be required by this Issue.