

December 15, 2021

SEC Chief Accountant  
Office of the Chief Accountant  
US Securities and Exchange Commission  
Accounting Interpretations via email  
OCARequest@sec.gov

RE: Cash Flow Hedge Relief Proposal Related to ASC 848, *Reference Rate Reform*

cc: Financial Accounting Standards Board

Ladies and Gentlemen of the Office of the Chief Accountant:

### **Executive Summary**

The relief provided under Financial Accounting Standard Board's (FASB) reference rate reform guidance (ASC Topic 848) does not explicitly address certain matters specific to cash flow hedges of pools of assets<sup>1</sup> applying a "first payments" approach to IBOR-based payments to be received by an entity. Absent the ability to apply relief to these hedging relationships, entities will likely be required to de-designate hedging relationships that are essential to their risk-management activities.

Specifically, the hedged forecasted IBOR-based payments are generated by an identified "pool" of assets that are either currently on the balance sheet or are expected to be originated during the life of the hedge to replace those assets as they are paid off (collectively, the "pool"). It is common for the pools of assets to have varying tenors, or to comprise varying products that have a common IBOR reference rate. These underlying assets are gradually transitioning to new reference rates ("replacement rates"<sup>2</sup>) and will ultimately be replaced in the pools with new items that are indexed to a new reference rate.

This transition period presents challenges that are unique to "first payments" approach cash flow hedges, as during the transition period entities will not be able to forecast the volume or sequence of cash flows generated by the pools that will reference legacy IBOR rates versus replacement reference rates, and further, entities will not be able to forecast whether the cash flows referencing a new reference rate were generated by items that transitioned from a legacy reference rate or were generated by items originated with that new reference rate.

The objective of the FASB's hedging relief is to allow reporting companies to continue to apply hedge accounting without interruption and to avoid significant incremental, though temporary, operational requirements to maintain hedge accounting until the earlier of (1) the Topic 848 sunset date (currently December 31, 2022<sup>3</sup>), or (2) the point at which the entity's hedging relationships no longer involve IBOR (either the hedging instrument or hedged transactions).

During the transition period, there will be circumstances where only a portion of the pool will also have transitioned to the new reference rate. As a result, the interest payments generated by the pool will reference a mix of legacy IBOR and replacement rates and during the transition period, it will be

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<sup>1</sup> The ARRC notes that this interpretation would include either liabilities or assets, however, this paper focuses on assets as its request item.

<sup>2</sup> "Replacement rates" are defined as those rates that entities consider to be replacements for existing IBOR contracts

<sup>3</sup> The ARRC notes there is a current proposal by the FASB to extend the sunset date to December 31, 2024 given the extension of certain tenors of USD IBOR.

impossible for entities to forecast (and operationally impractical to identify) the sequence of payments that reference legacy IBOR rates versus payments that reference replacement rates. This presents unique challenges in applying the hedge effectiveness relief in ASC 848-50-35-17 (precisely identifying a “mismatch” between the forecasted transaction and the hedging instrument), and in applying the guidance in 848-50-25-2 and 848-50-25-13 to IBOR-based forecasted transactions, on a hedge-by-hedge basis.

Absent the ability to apply relief as outlined in the following paragraphs, this inability to forecast the volume and sequence of legacy IBOR cash flows versus new reference rate cash flows will likely result in entities having to de-designate their cash flow hedges of pools of assets. Further, entities will not be able to designate new hedges until there is a sufficient volume of items that have transitioned to new reference rates and will provide a predictable volume of variable cash flows.

To address this concern, the Alternative Reference Rate Committee accounting subcommittee members (herein “ARRC”) are requesting SEC confirmation that there would be no objection to the following proposal:

1. Permit entities to amend their hedged forecast transaction to include replacement rates if the original hedge included rates that are expected to be affected by reference rate reform
  - a. Include newly originated replacement rate instruments within the relationship
  - b. Simultaneously, apply the additional cash flow hedge practical expedients at the same time that the hedged forecasted transaction is changed
2. Permit entities to allocate the hedging derivatives to the separate hedged forecast transactions<sup>4</sup> upon exit of the Topic 848 relief without de-designating and re-designating hedging relationships.
  - a. Continue to meet the probability requirements post exit, including through the inclusion of newly originated replacement rate loans in the pools

The ARRC believes these requests are consistent with the intent of the Topic 848 relief. Further, numerous safeguards exist to mitigate concerns of potential abuse of the flexibility provided by the relief.

Application of the cash flow hedging relief in Topic 848 merely allows the continuation of an existing highly effective hedge relationship during a temporary transition period, and any actual mismatch in reference rates between the hedging instrument and the hedged items will be reflected in earnings as the forecasted hedged transactions affect the income statement in net interest revenue. The inability to apply Topic 848 at the total hedged forecasted transaction<sup>5</sup> level could lead to unintended risk management outcomes which could be misleading to financial statement users (e.g., potential missed forecasts and the resulting reclassification of amounts deferred in Accumulated Other Comprehensive Income (AOCI) to earnings due to Topic 848 not contemplating pooled cash flow hedging programs.

As noted in paragraph BC. 77 of the Basis for Conclusions in ASU 2020-04, entities have already passed a high hurdle to apply hedge accounting by (at a minimum) satisfying hedge effectiveness assessments for existing hedges<sup>6</sup> in accordance with Subtopics 815-20 and 815-30.

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<sup>4</sup> Under the shared risk exposure guidance within ASC 815

<sup>5</sup> For purposes of this letter, the hedged forecasted transaction is at the pool level where all interest receipts meet the shared risk criterion, and it is at that level that ARRC seeks to apply the relief in Topic 848. An entity could hedge the entire pool or a portion thereof, and in either case the hedged forecasted transaction is the amount being hedged.

<sup>6</sup> The Topic 848 relief also explicitly allows for expedient hedge effectiveness assessment methods to be applied to new hedging relationships that are executed during the relief period. The ARRC would seek to apply the

Finally, application of this relief is a temporary measure to address a unique situation related to the discontinuation of IBOR. Entities will be required to revert to the cash flow hedge accounting requirements in Subtopics 815-20 and 815-30 for any cash flow hedging relationships that would remain in place after the earlier of the sunset date or the date that a hedge relationship (or, assuming the SEC does not object to ARRC's position, a hedge program) no longer references IBOR rates.

### **Background**

Banks maintain significant loan receivables on the balance sheet that are indexed to multiple IBOR rates. As floating-rate loan receivables originated by core banking businesses are subject to the variability of future interest receipts, banks designate multiple cash flow hedges over the portfolios of IBOR-indexed loans (generally 1-month IBOR or 3-month IBOR) to manage their exposure to interest rate volatility. As the loans and receivables within each hedge relationship share the same risk exposure, banks typically group them into rolling pools and designate interest rate derivatives as hedges against the forecasted interest receipts of the pools. For hedging purposes, the forecasted interest receipts commonly include those generated by existing contracts as well as those to be generated by contracts that will be originated at a later date. Cash flow hedges are created based on banks' expectations and the probability of occurrence; for example, banks expect a certain amount of 1-month and 3-month IBOR contracts (and associated interest receipts) and therefore hedge a subset of that expected amount (i.e. the hedged forecast transaction).

Banks hedge the forecasted interest receipts using the "first-payment-received technique", as contemplated in ASC 815-20-55-91 through 96. In approving this technique, the FASB's Derivative Implementation Group referenced the FASB's recognition in SFAS 133's Basis for Conclusions that it "sometimes will be impractical (perhaps impossible) and not cost effective for an entity to identify each individual transaction that is being hedged", and therefore allowed transactions to be grouped provided that they share the same risk exposure (i.e., the interest rate index).

In order to conclude each period that forecasted transactions remain probable of occurring, an entity is required under the first-payments-received technique to assess whether it expects to continue to receive interest receipts ("payments") on loans that are at least equal to the designated amount of loan principal. Consistent with the Board's conclusion about the impracticability of assessment on a cash flow by cash flow level, this "volume test" is performed in the aggregate. Banks typically use multiple derivatives (designated singly and not in combination) to hedge designated amounts of forecasted interest payments, with the first derivative typically designated as hedging the first-received amount of interest payments, and the second derivative designated as hedging the "second"-received amount of interest payments, and so on.

Prior to IBOR transition, the forecasted interest payments came from a pool of existing and forecasted items that shared the same risk exposure. Therefore, the interest receipts were fungible regardless of the order of payments received first, second, and subsequent. To ensure that in the event of a partial failed forecasted transaction that an amount of AOCI is released in a systematic and rational method, the order of the derivatives is typically sequenced, and the related AOCI is tracked by derivative. Each derivative is assessed for effectiveness against the corresponding forecasted cash flows designated as hedged.

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interpretations herein to those hedges as well. The Board's rationale for this decision is discussed in BC. 83 through BC. 85, which are included in Appendix A for reference.

As the industry ceases originating loans indexed to IBOR, banks are originating loans that reference replacement rates in addition to modifying existing loans through the final cessation of IBOR on June 30, 2023. In October 2021, the ARRC announced its recommendation that banks cease new issuances of IBOR referencing instruments by December 31, 2021. Customer-facing transition efforts are also underway to gradually transition existing loans from IBOR to other replacement rates; however, there remains significant uncertainty with respect to how the transition will be affected in the respective markets due to the extended transition period, significant transition volume, and modification complexity.

Lending markets in which loans reference certain term rates (e.g., 1-month IBOR or 3-month IBOR) may not transition to a similar term rate in replacement rate markets, and further may not all transition to the same term rate or overnight rate convention. For example, a 1-month IBOR loan market may evolve to have both term and overnight replacement rates for different client segments or lenders. A bank with a 1-month IBOR pool and a separately designated 3-month IBOR pool of equal amounts may end up with a medium sized 1-month term SOFR pool, a small 3-month term SOFR pool and a large overnight SOFR pool from the same initial client lending relationships or new relationships within the same business. In order for entities to maintain their cash flow hedge programs during IBOR transition and exit to qualifying Topic 815 cash flow hedging relationships upon the cessation of IBOR, the ARRC requests that certain interpretations of Topic 848 relief guidance be permitted during the IBOR transition period and upon exit when IBOR rates are no longer present in the hedging relationships.

## **Request for Confirmation of No Objection**

The ARRC is asking the SEC staff to confirm that it would not object to the below interpretations of the application of the Topic 848 expedients:

### **Part I – Entering the Relief**

#### *Changing the hedged forecasted transaction*

Question(s): Can entities apply ASC 848-30-25-5 to change the hedged forecasted transaction to include both IBOR and a replacement rate(s)?

Can the change be made in advance of the existence of interest payments based on a replacement rate?

Can the replacement rate(s) used to identify the hedged forecasted transaction be changed multiple times during the relief period?

ARRC View and Interpretation: Yes. Entities may amend their current hedge documentation to include both the original IBOR cash flows and the successor replacement rate(s) cash flows in the same hedge. As long as the hedged forecasted transactions include payments indexed to rates that are expected to be impacted by reference rate reform, there is nothing that prohibits an entity from amending the hedged forecasted transaction multiple times (e.g., if additional new replacement rates are expected to be added to the pool) during the relief period.

Further, entities may apply the changes to the hedge documentation simultaneously to all hedging instruments designated against forecasted interest receipts, whether generated by recognized financial assets or expected future originations. The amended hedge documentation is a group of forecasted interest receipts, and is not tied to identification of specific contracts that will generate such interest receipts. Due to the fact that all of the forecasted hedged transactions and hedging derivatives are expected to be affected by reference rate reform and therefore meet the qualifying criteria to apply this paragraph, the ARRC believes this is the appropriate level at which to apply the guidance. The following summarizes the technical support for this view:

- ASC 848-30-25-3 allows an entity to change the critical terms of a hedging relationship because of an election of an optional expedient and not be considered a de-designation.
- ASC 848-30-25-5 allows an entity to change the contractual terms of hedging instruments and forecasted transactions that are affected or expected to be affected by reference rate reform and not be required to de-designate the hedging relationships if the changes to the contractual terms meet the scope of paragraphs 848-20-15-2 through 15-3 (i.e., that the modifications replace or are expected to replace an in-scope reference rate).
  - ARRC believes that changing the critical terms of the hedged forecasted transactions to include both the originally designated IBOR interest payments (as long as they continue to be made) and those of any successor replacement rates in the same hedge meets the intended scope of the relief, and that such changes to the hedge documentation can be made immediately, as all IBOR rates are expected to be affected by reference rate reform. ARRC does not believe that actual contractual modifications to individual loans or derivatives in the pool are required for entities to enter and begin applying the relief because the forecasted hedged transaction and the hedging derivatives are inherently

expected to be affected by reference rate reform, which meets the scoping requirement in ASC 848-10-15-3.

- IBOR interest payments, as a general matter, are expected to be affected by reference rate reform, as they are expected to be replaced by interest payments indexed to replacement rates. Banks are actively engaged with clients that have IBOR-referenced financial instruments and are seeking for those clients to agree to remediation, including insertion of fallback language, amendment, and unwind/replacement, and are executing those remediations as soon as clients are willing and able to do so. Certain loan market segments have already replaced material amounts of IBOR based loans with replacement rate referenced loans.
- ARRC acknowledges that interest payments will likely not be homogeneously received over the hedge period, and some derivatives may conceptually align with the receipt of either solely IBOR cash flows, solely replacement rate cash flows, or mixed rate cash flows, respectively. With respect to IBOR transition, banks are not able to accurately forecast the exact transition dates for individual client relationships that make up the group of contracts included in the pool and therefore are unable to accurately forecast specific amounts of IBOR-related cash flows and replacement rate cash flows in a designated hedge period. In addition, the order of cash flow receipts will change over time, as payment timing is controlled by debtors, and not by banks. Therefore, banks will need to apply hedge documentation changes focused on the total hedged forecasted transaction level, which are the forecasted interest receipts generated from the pool, rather than at the level of each individual cash flow from each individual asset within the pool. This remains consistent with the acknowledgement by the FASB referenced above, that it is not practical, possible, or cost effective for an entity to identify each individual cash flow that is being hedged and the order in which it is received and then comparing it to a specific hedging instrument.
- Further, while entities will use their best estimates to specify the replacement rates that would be included within the individual pools, it may be possible that some of the cash instruments could transition or originate outside the initially specified replacement rates that may be needed in order to satisfy the volume test under the cash flow hedge criteria. Therefore, the ARRC is asking for an ability to make multiple amendments over a transition period to the different replacement rates designated as the hedged forecasted transactions in the pools being hedged and the associated levels, where necessary. Alternatively, the ARRC would request that the SEC staff provide relief around the specificity requirements under ASC 815-20-25-3(d)(1)(vi) during the relief period through exit.

Consequence(s) if this interpretation is not permitted:

- If this interpretation is not permitted, there are multiple potential outcomes, none of which would reflect the risk management that investors are expecting through the IBOR transition period.
  - If entities are unable to change the hedge forecasted transaction to include payments based on replacement rates (in addition to IBOR cash flows) then entities will have missed forecasts and de-designated hedge relationships as IBOR payments decline.
  - If entities are unable to change the forecasted hedge transaction until there is a non IBOR cash flow in the pool, there could be further delays in transition where entities are planning for IBOR transition but are unable to apply the relief until a replacement rate cash flow actually enters the pool.
  - If the view is that the relief would be applied at the individual derivative level and not at the total hedged forecasted transactions level (which are interest receipts from a pool of

assets), entities would be required to track which specific cash flows are matched with each derivative. If one or multiple of these individually matched relationships contain only IBOR cash flows, those matched relationships would not be permitted to enter the relief. For those matched relationships, entities may be required to de-designate, leaving them partially unhedged from an accounting perspective during the transition period, which would not be aligned with the risk management objectives of banks.

- The above assumes that it would be possible to trace the cash flows to the individual derivative level. For some entities, this tracing may not be possible and/or cost effective, which is acknowledged in the Basis for Conclusions under SFAS 133 as noted above. For those entities, it would not be possible to apply the relief at all and they would face failed forecasts and be required to de-designate for the entirety of the transition period.
- Neither of these outcomes is consistent with the intent of the ASC 848 relief, which is to allow entities to *maintain their current levels* of hedging through existing hedge programs, not to require partial or full de-designation.
- If the view is that the changes to hedge documentation must state specific quantities of each replacement rate in order to meet the sufficient specificity requirements in ASC 815, and those replacement rates and related quantities cannot be subsequently amended over the transition period, entities would face potential failed forecasts leading to de-designation (which could be misleading to financial statement users, e.g., potential reclassification of amounts deferred in AOCI to earnings due to Topic 848 not contemplating pooled cash flow hedging programs). Due to the increased uncertainty related to IBOR transition, replacement rates are still being determined and negotiated with clients; therefore, entities are unable to predict with a high level of confidence the ultimate levels and timing of each replacement rate. More general updates to hedge documentation during the transition period are required in order to ensure that the hedge relationships remain highly effective throughout IBOR transition.

#### *Newly-originated replacement rate contracts and short-dated IBOR contracts*

Background: ASC 848-30-25-5 states that “An entity may change...a forecasted transaction...that is affected or expected to be affected by reference rate reform and not be required to de-designate the hedged relationship if the changes to the contractual terms meet the scope of paragraphs 848-20-15-2 through 15-3”.

Question(s): Can the relief guidance be applied to new replacement rate derivative contracts and forecasted interest receipts from newly originated replacement rate loans?

Can the relief guidance be applied to forecasted interest receipts from a pool of assets that includes short-dated IBOR contracts that will mature prior to IBOR cessation?

ARRC View and Interpretation: Yes.

- While certain cash flows are easily identifiable as “expected to be affected by reference rate reform” as those cash flows are expected to occur beyond the published cessation date for the IBORs, others are scheduled to occur prior to IBOR cessation dates.
- Because the “first-payments-received technique” involves the designation of the first payments from a pool of loans or expected originations and not payments on specific loans, payments received on short-dated loans that mature earlier than the designated tenor of the hedged

relationship are eligible hedged forecasted transactions to be hedged within a group under Topic 815.

- ARRC believes that since the hedged forecasted transactions are a group of transactions, rather than a single transaction, and because the FASB acknowledged in the basis for conclusions in SFAS 133 that it would be impracticable or impossible to identify individual transactions within the group, that all IBOR cash flows previously designated as hedged should qualify to remain in the pool even if the transactions generating some of the cash flows will mature prior to the cessation of the specifically referenced IBOR. As regulatory authorities across jurisdictions have strongly encouraged market participants to actively transition their portfolios prior to the actual IBOR cessation dates, banks are actively engaging with clients to transition both cash and derivative transactions as quickly as clients are able. For these reasons, ARRC believes that it is reasonable to expect that any interest receipts generated from the pool of assets should qualify as “expected to be affected by reference rate reform” in 848-30-25-5.
  - Further, inherent in cash flow hedges are forecasted transactions. The ARRC believes newly originated replacement rate cash flows would also meet the requirements of the above paragraphs, as while not directly being amended from IBOR to replacement rates, the transition away from IBOR requires entities to cease executing new instruments with IBORs and instead replace maturing instruments with replacement rates. These replacement rate transactions (cash flows and derivative contracts) are affected by reference rate reform because absent reference rate reform, it is highly likely that these instruments would have been executed with IBOR rates.

Consequence(s) if this interpretation is not permitted:

- If the interpretation that newly originated replacement rate transactions can be included in the existing cash flow hedge is not permitted, there will be severe disruption to cash flow hedge programs during the relief period.
- For example, if the ASC 848 relief cannot be applied to newly originated SOFR derivatives and forecasted interest receipts generated from newly originated SOFR loans, it is highly unlikely that entities will continue to be able to meet the volume requirements through the relief period. As derivatives and loans mature, they will need to be replaced. Given the announcement by the ARRC that entities are advised to discontinue new IBOR issuances at the end of 2021, the only option that entities have is to replace maturing IBOR contracts with non IBOR replacement rates.
- If the new non IBOR issuances are not permitted to apply the relief as a part of the existing cash flow hedge program, entities first would have to de-designate their existing IBOR and replacement rate hedges to the level they could assert related to instruments that originally were IBOR based and subsequently amended.
- Then, for newly originated replacement rate contracts, an entity could wait until there is a critical mass of replacement rate cash flows to begin a new cash flow hedge program. This de-designation and creation of a new hedge could be considered a step down and step up approach.
- There are several additional considerations related to this step down/step up approach:
  - The IBOR derivatives would be non-zero at the time of de-designation. Therefore, if an entity wanted to use the existing derivatives as part of its new cash flow hedge, it would need to separate out the financing component in order to use them. This is often neither cost effective nor operationally expedient.
  - There may be a breakage of time between de-designation and ramp up of the new non IBOR hedge, that essentially would leave an entity unhedged (from an accounting perspective) and unable to utilize a risk management tool that investors had expected



- entities to use both as part of their normal risk management strategy and a risk management tool to facilitate an easy and non-impactful transition away from IBOR rates.
- If an entity is able to utilize the IBOR based derivatives at a later date, it should be able to utilize the ASC 848 relief as the cash products and IBOR derivatives will be mismatched and therefore qualify for the relief. However, it is more likely that entities will choose to replace the derivatives and therefore would be unable to apply the Topic 848 relief as the new replacement rate derivatives and the replacement rate loans would not be IBOR-based and therefore would not qualify for the relief.
  - Due to the heightened level of uncertainty during the transition period, it would be extremely difficult, if not impossible, for entities to predict the ultimate level of cash flows that will transition to specific non IBOR replacement rates after the transition period, meaning that entities could face potential failed forecasts if their predictions do not come to fruition. To avoid this, entities may choose to wait to develop the new cash flow hedge program until ultimate levels are known, leaving them unhedged from an accounting perspective during the transition period, which is not consistent with investor expectations or effective risk management strategies.

Question: Can entities apply the additional practical expedients listed below at the same time the hedged forecasted transaction is changed in advance of the existence of replacement cash flows?

ARRC Interpretation: Yes, this application of the below practical expedients should be permitted to be applied at the same time the hedged forecast transaction is changed, which is when the transaction is expected to be affected.

The interpretations outlined above would allow entities to apply other practical expedients on a pool basis included within ASC 848 as noted below:

- **Applying Practical Expedients:** Entities would apply the following practical expedients in Topic 848 during the relief period<sup>7</sup>.
  - **Similar Risk Exposure (ASC 848-50-25-13 through 25-14):**
    - The ARRC notes that IBOR and its replacement rates may not share the same risks and therefore would apply the similar risk exposure practical expedient to combine these different indexes by tenor (1-month separate from 3-month).
    - In terms of the level of application of these expedients, entities would look to apply the relief on a pool basis. The hedged transactions are the first forecasted interest payments related to identified pools of assets (loans) with interest payments that explicitly vary with contractually specified interest rates, (e.g., 1-month or 3-month IBOR) grouped by contractually specified rate. During IBOR transition, the only change to this designation would be the contractually specified rate; that is, the hedged forecasted transaction would include not only 1-month or 3-month IBOR cash flows, but also include replacement rates.
    - To qualify for the similar risk exposure practical expedient, ASC 848-50-25-13 states that a forecasted transaction in the hedged group of forecasted transactions must reference a rate that meets the scope of paragraph 848-10-15-3 (i.e., the rate references IBOR or another rate expected to be discontinued due

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<sup>7</sup> Entities would also apply the practical expedients in ASC 848-30-25-6 and 848-30-25-8 which state that derivative terms and hedge documentation can be modified without de-designation, respectively. However, these practical expedients are not specific to this hedge type and therefore have not explicitly been mentioned herein.

to reference rate reform). Entities would demonstrate that the qualifying criteria are met through an assertion that the conditions would be met “if it is deemed that the forecasted transaction includes interest receipts that reference IBOR or another rate expected to be discontinued.” The ARRC believes applying this requirement at the total forecasted hedged transaction level is most appropriate and acknowledges that the total forecasted hedged transaction is made up of a group of transactions that exist or may exist in the future and that contain IBOR. However, the ARRC is not required to individually assess each individual transaction within the group so long as it can establish the existence of IBOR more broadly.

○ **Hedge Effectiveness Assessment (ASC 848-50-35-17):**

- ARRC believes that the most practical way to perform effectiveness testing during the relief period is to continue using the hypothetical derivative test. Operationally, this would allow entities to assume their forecasted transactions and hedged risk are the same as the actual derivative, even as loans in the portfolio transition away from IBOR<sup>8</sup>. However, the ARRC notes that Topic 848 allows other methods of effectiveness testing relief in compliance with the relief guidance.
  - During the relief period, entities are further permitted to assume that IBOR will not be replaced in subsequent assessments.<sup>9</sup>
  - In addition, ARRC believes that entities can apply effectiveness assessment relief (ASC 848-50-25-11b and ASC 848-50-35-17b) if it is deemed possible there will be a mismatch in the future from forecasted transactions that now reference both IBOR and other replacement rates based on the updated hedge documentation.
  - The ARRC notes entities would continue to monitor and assert that (at the pool level) it is probable that there are sufficient forecasted hedged items expected to occur (this would include IBOR cash flows and replacement rate cash flows) but would not reflect the timing of receipt of each loan’s cash flow each period in the hypothetical derivative(s) (i.e., the assessment would ensure that the aggregate amount of loan principal exceeds the aggregate amount of derivative notional designated as hedged, such that it would be clear that adequate loan interest payments were received across all indices each period, but the sequencing of the receipt of those payments would not be modeled into each hypothetical derivative).
- **Exiting the Relief:** Entities will exit the relief at the earlier of (i) the sunset date or (ii) once both the hedged items and hedging instruments in the pool no longer contain references to IBOR.

Consequence(s) if this interpretation is not permitted:

If entities are able to amend the hedged forecasted transaction in advance of being affected by a replacement rate cash flow but unable to apply the similar risk practical expedient at the same time, it may not be possible for an entity to comply with ASC 815 as IBOR and replacement rates would not meet the similar risk criteria. Therefore, entities would have to time their use of the similar risk criteria and therefore hedge effectiveness testing when the pool is impacted by replacement rate cash flows and amend the hedge forecasted transaction at that time. While this delay is a reasonable interpretation, the ARRC believes that this delay is unnecessary given that all of the interest receipts and derivatives in the

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<sup>8</sup> That is, during the relief period, entities would assume the hypothetical derivative is equal and offsetting to the actual derivative.

<sup>9</sup> As per ASC 848-50-35-17(a)

hedge relationship are expected to be affected by reference rate reform and therefore see no practical reason that would drive a delay in the usage of the Topic 848 relief guidance.

### **Exiting the Relief:**

There is exit guidance in the Topic 848 relief which explicitly contemplates entities making certain changes to their hedge documentation including changing the hedge effectiveness testing. However, when this relief was drafted, ARRC's expectation was that updated change in hedged risk guidance (the FASB's proposed ASU on codification improvements to ASC 815) would be published in time to apply post-Topic 848 sunset date. While we understand the FASB is focused on this issue, given that this guidance has not yet been published, entities will need an interim ability to reallocate hedged transactions upon exiting the Topic 848 relief given the change in hedged risk away from IBOR and the uncertainty around the replacement rates and volumes thereof.

Further, ARRC believes that from a practical standpoint the entire group of hedged forecasted transactions and the associated hedging instrument(s) should be permitted to exit the relief together. Otherwise, it would be unclear which derivatives would be allocated to the exited portion of the cash flows and vice versa.

#### *Hedge Effectiveness Assessment Upon Exit*

ARRC believes that subsequent to the amendment of the hedge documentation in accordance with paragraph 848-50-25-3 to include rates other than IBOR (i.e., replacement rates), the mismatch<sup>10</sup> between the forecasted transactions and hedging instruments ceases to exist upon the earlier of sunset date or the completion of both loans and derivatives IBOR conversion.

Therefore, ARRC interprets ASC 848-50-35-19 in a way consistent with the entry point that the discontinuance of effectiveness assessment relief in ASC 848-50-35-17b should cease upon complete IBOR exposure disappearance at the group of hedged forecasted transactions level. Concurrently, in accordance with ASC 848-50-35-20, entities are permitted to elect any hedge assessment method in Topic 815 without de-designation – the chosen method does not need to be the same method used before election of the optional expedients in Topic 848.

### **Exit Request:**

Depending on the emerging replacement rates upon exit, the ARRC is requesting the SEC not object to entities amending the size of the designated hedged risk(s) of, and numbers of pools within the overall pool (as discussed earlier) for the total volume of cash flows designated as hedged in the pool under the shared risk criteria. Upon exit, entities would assess the shared risk attributes of each variable rate instrument in the pool(s) and aggregate those that share the same risk exposure. Immediately prior to the exit of the relief, as long as the total volume of cash flows designated as hedged is the same or greater than the previously designated volume of IBOR-based cash flows, entities would not recognize a failed forecasted transaction. This will require the ability to update hedge documentation to change the documented size of the forecasted transactions and hedged risk in individual hedging relationships. To that end, the ARRC also requests the non-objection to the one-time ability to reallocate (and if necessary, amend or add to<sup>11</sup>) the associated derivatives to align with the levels of cash flows being hedged under each replacement variable rate, that meets the definition of similar risk under ASC 815<sup>12</sup>. Since some cash instruments are being converted to replacement rates that differ from the derivatives originally used to hedge them (e.g., Term SOFR cash flows with O/N SOFR derivatives), amendments to the derivative(s)

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<sup>10</sup> ASC 848-50-35-17b

<sup>11</sup> Entities would also be permitted to add/amend derivatives consistent with ASC 848-30-25-9

<sup>12</sup> ARRC is not seeking to combine rates that do not meet these requirements upon exit of the Topic 848 relief.

may also be necessary. However, ASC 815 only requires a shared risk exposure among a portfolio of cash flows, and only requires a highly effective hedging instrument and not matched terms. The allocation process requested by the ARRC will comply with the shared risk exposure and highly effective requirements, which may require a resequencing of the existing derivative sequence.

#### Unintended Consequences

An inability to change the size of the documented forecasted transaction and hedged risk in individual hedging relationships could result in failed forecasts for entities' existing cash flow hedge programs, hedging relationships failing to qualify for hedge accounting upon exiting the relief in Topic 848, and other operational challenges associated with maintaining and identifying separate portfolios upon transition. A failed forecast would require de-designation and the potential for an immediate reclassification of amounts deferred in AOCI to earnings, which goes against the intent of the Topic 848 relief to help entities maintain their cash flow hedge programs during and after IBOR transition. Additionally, a reclassification of amounts deferred in AOCI to earnings due to a failed forecast from rigid accounting guidance and interpretations and not a change in risk exposure (i.e., Topic 848 not contemplating pooled cash flow hedging programs) would be both unrepresentative and misleading to financial statement users.

While Topic 848 does not include explicit transition guidance specific to the request in this submission, the intent is to allow entities to maintain the same level of cash flow hedging, just under replacement rates. Therefore, the volume of hedges prior to transition should be permitted to be maintained through the use of one or multiple replacement rates. Derivatives are all moving away from IBOR and will have a non-zero value at the time of transition. If entities were required to de-designate in order to reallocate the derivatives to different rates, this could lead to less effective (and potentially ineffective hedges) and as a result it could become costly as entities may be required to settle and enter into new derivatives.

#### *Ability to Apply the Probability Requirement Upon Exit*

Question: Are entities permitted to continue to meet the probability requirements upon exit, including through the use of newly originated replacement rate loans?

ARRC View: Yes.

- **Upon exit:**
  - If entities are permitted to update the hedged forecasted transaction and designated hedged risk upon exit, ARRC believes this updated designation should permit an entity to meet an assertion that the cash flows continue to meet the probability requirements so long as the replacement rate cash flows are aligned with the entity's updated hedge documentation.
  - In other words, if an entity forecasts two \$5 billion pools of 1-month and 3-month IBOR rates for 5 years, replacement rate cash flows of \$10 billion or more throughout the remaining hedge maturity date will satisfy this prior commitment, regardless of the allocation of various replacement rate cash flows grouped based on similar risk criteria post exit date. Specifically, entities with longer term hedge relationships may need to allocate them among newly established pools indexed to different replacement rates upon exit of the relief as the market demand for multiple replacement rates is expected to continue to change. The composition after the transition period should not result in failed forecasts if entities continue to maintain sufficient hedged forecasted transactions indexed to replacement rates at the aggregate level. In other words, if the volume of IBOR and replacement rate cash flows remain at the pre-IBOR forecasted hedge transaction level but under ASC 815 can no longer remain combined because the rates fail the similar risk criteria once Topic 848 expires, the combination of these separate hedges should be

considered to satisfy the probability assessment regardless of the rates and number of relationships.

- ASC 815-30-55-57 has an example that AOCI release into earnings is separate from the effectiveness assessment. After entities amended their cash flow hedge documentation to reflect the revised hedged risks, the existing guidance should support the view that aggregate cash flows in multiple replacement rates meets the probability requirement upon exit.

Consequence(s) if interpretation is not permitted:

- If this interpretation is not permitted, entities are at risk of failing the probability assessment, which could lead to de-designation during the relief period or in advance of applying any of the permissible Topic 848 relief components. The ARRC does not believe this is consistent with the intent of the accounting relief, which is to allow entities to maintain their current level of hedging during the transition period and upon exit.
- The announcement of the extended publication of certain tenors of USD IBOR and regulator recommendations that entities cease new IBOR issuances prior to that date are events outside of banks' control. If the ARRC's interpretation is not permitted, these uncontrollable events would prohibit banks from meeting the probability assessment no matter what internal mitigating actions they would be prepared and willing to make in order to meet these requirements.

**Safeguarding Factors**

The application of such relief outlined above is merely the continuation of an existing highly effective hedge program or the execution of new hedges during a temporary transition period and the ARRC has no reason to believe this will lead to abuse or be deemed to be a misrepresentation. As a result of the adoption of ASU 2017-12, cash flow hedges no longer recognize ineffectiveness in earnings, however the actual mismatch in reference rates between the hedging instrument and the hedged items will be reflected in earnings as the forecasted hedged transactions affect the income statement and such amounts will be reflected in interest income.

Finally, and most importantly, the application of this relief is a temporary measure that will allow entities to continue to apply much needed hedge accounting to variable-rate transactions in the face of significant uncertainty caused by the discontinuation of IBOR, without having to create significant incremental and temporary operational processes resulting in unnecessary transition burdens.

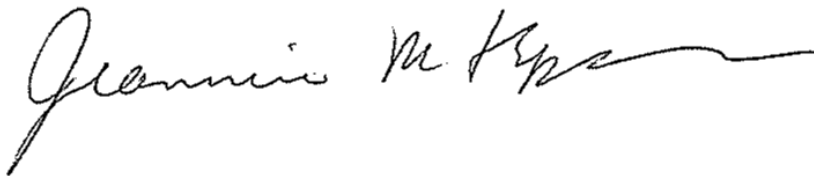
Please see Appendix A for relevant excerpts from the Basis for Conclusions.

**Conclusion**

As part of developing this position, the ARRC has obtained feedback from EY, KPMG, PWC, and Deloitte (collectively the “accounting firms”), which we have included below:

The accounting firms agree that cash flow hedges of pools of assets that apply a "first payments" approach present unique challenges that are not directly addressed by ASU 2020-04 (Topic 848). The accounting firms also agree that the ARRC's proposed expansion of the provisions of Topic 848 would alleviate many of these challenges to maintaining hedge accounting during and after the transition period, and therefore the accounting firms support the ARRC's effort to discuss these matters with the SEC staff.

The ARRC Accounting and Tax Sub-Committee members appreciate the Staff's consideration of this issue and would welcome the opportunity to discuss it further. Should you have any questions or desire further clarification on any of the matters discussed in this submission, please do not hesitate to contact Jeannine Hyman at (212) 816-2114.

A handwritten signature in black ink, reading "Jeannine M. Hyman". The signature is written in a cursive style with a long horizontal flourish extending to the right.

Sincerely,

Jeannine Hyman  
Citigroup, Inc  
Chair of the ARRC Accounting and Tax Subcommittee

## **Appendix A: Support from the Basis for Conclusions to Topic 848**

*BC68. Similar to its reasoning for fair value hedges, the Board concluded that existing cash flow hedges that are affected by reference rate reform should be permitted to continue without de-designation because those hedging relationships continue to reflect an entity's intended risk management strategy. The Board also concluded that new cash flow hedges that are affected by reference rate reform because either the hedging instrument or the hedged item references IBOR or another rate expected to be discontinued should be permitted to qualify for hedge accounting because those hedging strategies also would reflect an entity's intended risk management strategy.*

*BC69. The Board concluded that without the optional expedients in the amendments in this Update, there would be an increased level of complexity in performing hedge effectiveness assessments for cash flow hedges that are expected to be affected by reference rate reform. For example, in a cash flow hedge that qualifies for hedge accounting, the reference rate in the hedging instrument and the reference rate in the hedged forecasted transaction may be replaced at different times during the hedging relationship. An entity would need to estimate the expected timing of when the hedging instrument and the hedged forecasted transaction will transition to the replacement rates—including for hedges of groups of forecasted transactions in which individual forecasted transactions in the group may have different transition timing—and incorporate those timing estimates into the hedge effectiveness assessment.*

*BC70. In addition, without the amendments in this Update, there may be periods of time during the transition to replacement rates in which a cash flow hedge would not be considered highly effective for the purposes of Subtopic 815-20 because of the basis differences between the reference rates in the hedging instrument and the reference rates in the hedged forecasted transaction. The Board determined that the discontinuance of hedge accounting in those cases will not provide decision-useful information to users of financial statements.*

*BC71. In providing the optional expedients for cash flow hedges affected by reference rate reform, the Board placed importance on several other provisions in hedge accounting guidance as a counterbalance to the flexibility that is provided by those optional expedient methods. First, the amendments in this Update rely on the guidance in Subtopic 815-20 that was added in Update 2017-12 to remove the concept of separately measuring and recognizing hedge ineffectiveness. Accordingly, if a hedging relationship qualifies for cash flow hedge accounting, all changes in the fair value of the derivative designated as the hedging instrument are deferred into accumulated other comprehensive income and recognized in earnings when the hedged forecasted transaction affects earnings.*

*BC72. Second, the amendments in Update 2017-12 added presentation guidance for hedging relationships such that the effects of the hedging instrument are required to be recorded in the same line item as the earnings effect of the hedged item. The Board considers that presentation guidance to be a safeguard for the application of the optional expedients for cash flow hedges. That is, the Board acknowledges that cash flow hedges for which an entity elects the optional expedients may not satisfy the requirement in which the hedging instrument is expected and actually shown to be highly effective in offsetting changes in cash flows due to changes in the hedged risk during the period that the hedge is designated. The Board understands that hedging relationships that are not highly effective may qualify for hedge accounting as an outcome of providing relief provisions that enable an entity to continue to reflect its intended risk*

*management strategies in the financial statements for the period that reference rates are expected to transition to replacement rates.*

*BC74. For cash flow hedges, if either the hedged forecasted transaction or the hedging instrument references IBOR or another rate expected to be discontinued because of reference rate reform, the amendments in this Update allow an entity to effectively suspend subsequent hedge effectiveness assessments as long as the entity determines qualitatively that the following conditions continue to be met each period:*

- a. The hedged forecasted transaction or the hedging instrument references an eligible rate.*
- b. There have been no changes to the terms of the hedging instrument or the forecasted transaction other than those related to reference rate reform.*
- c. An entity considers the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity.*

*BC75. The Board decided that an entity may switch to the shortcut method to assess subsequent hedge effectiveness if it elects to apply that optional expedient for the cash flow hedge. However, the Board decided not to provide similar relief for fair value hedges. The Board reasoned that under the fair value shortcut method, a change in fair value of a swap designated as the hedging instrument would be used as a proxy for the change in fair value of the hedged item, and if the variable rate on the swap did not match the designated benchmark interest rate, there would be a true fair value difference. However, because all changes in a swap designated as a hedging instrument in a cash flow hedge are recorded in other comprehensive income, there is no difference between the reporting effect of a cash flow shortcut method and the reporting effect of a quantitative method if the hedge is highly effective.*

*BC76. An entity also may elect optional expedients that allow it to adjust the methods for assessing subsequent hedge effectiveness in current GAAP so that the entity could remove from its assessment the differences between the hedged forecasted transaction and the hedging instrument that are due to the changes in the reference rates and the timing of when the rates reset. The Board determined that an entity should have the option to adjust existing quantitative methods of assessing subsequent hedge effectiveness rather than assuming perfect hedge effectiveness or qualitatively assessing certain conditions each period, which introduces a new process for hedging relationships affected by reference rate reform. The Board anticipates that some entities may want to adjust existing quantitative methods and processes for subsequently assessing hedge effectiveness for hedging relationships that extend beyond the December 31, 2022 expiration of the optional expedients and are required to revert to existing GAAP.*

*BC77. The Board observes that cash flow hedges that have already qualified for hedge accounting by (at a minimum) satisfying an initial hedge effectiveness assessment in accordance with the requirements of Subtopics 815-20 and 815-30 have already passed a high hurdle to apply hedge accounting. Therefore, in the Board's view, it is unlikely that the hedging relationship will significantly deviate from the results of those previous hedge effectiveness assessments and that a change in the terms as a result of reference rate reform will not be expected to introduce excessive levels of hedge ineffectiveness. The Board adds that for the periods of an expected or actual mismatch in reference rates between the hedging instrument and the hedged item, an entity should be able to continue to portray in its financial statements the continuation of its original risk management strategy, especially considering that any mismatch will be reflected in earnings.*



*BC78. For similar reasons, the Board decided that an entity may disregard the shared risk exposure guidance in Subtopic 815-20 for a group of individual forecasted transactions in a cash flow hedge if a single forecasted transaction in the hedged group of forecasted transactions references IBOR or another rate that is expected to be discontinued. However, an entity is not allowed to group interest receipts with interest expenses or forecasted purchases (including debt issuances) with forecasted sales.*

*BC82. The Board decided that extending relief to new cash flow hedges affected by reference rate reform is appropriate during the period of transition to replacement reference rates because an entity may enter into cash flow hedging relationships during that period that could have an immediate mismatch in rates. Because of the uncertainty on how reference rate reform will be effectuated in the respective markets, including across different derivatives and other financial instrument products, the immediate mismatch may be because of market-wide developments outside the control of an entity's risk management activities, such as the lack of liquidity of certain derivatives to match the underlying reference rate index of a replacement reference rate. The Board determined that the lack of hedge accounting should not hinder the development of those new markets. The Board also notes that given the uncertainty about the timing of the transition of different instruments and products, it is unclear whether an entity would be able to obtain derivatives referencing desired rates.*

*BC83. The amendments in this Update do not include incremental criteria for determining whether an optional expedient for new cash flow hedges may be elected. The Board notes that it is challenging to create criteria that do not diminish the objective of providing relief for application of the hedge accounting requirements during the period of market transition to replacement reference rates. The Board considered an approach that would limit the reference rates that could be incorporated into a hedging relationship that qualifies for optional expedients. However, as noted in paragraph BC23, in the Board's view, the amendments should remain neutral on eligible replacement rates, which creates a challenge for introducing such a limitation.*

*BC84. As an alternative, the Board considered requiring an initial assessment of hedge effectiveness using an existing method in Subtopics 815-20 and 815-30. However, the Board recognizes that when the reference rate of the hedging instrument and the hedged item differ at the inception of the hedging relationship, the requirement of an expectation that the hedge will be highly effective may not be satisfied. The Board observed that this is no different in the case of an initial assessment for a new hedge as compared with a subsequent assessment for an existing hedge.*

*BC85. As noted in paragraph BC70, the Board acknowledges that cash flow hedges for which an entity elects the optional expedients for initial assessment of hedge effectiveness may not be highly effective during the period that the hedge is designated. The Board accepts that as an outcome of providing temporary relief provisions enabling an entity to continue to reflect its intended risk management strategies in the financial statements during the transition period.*