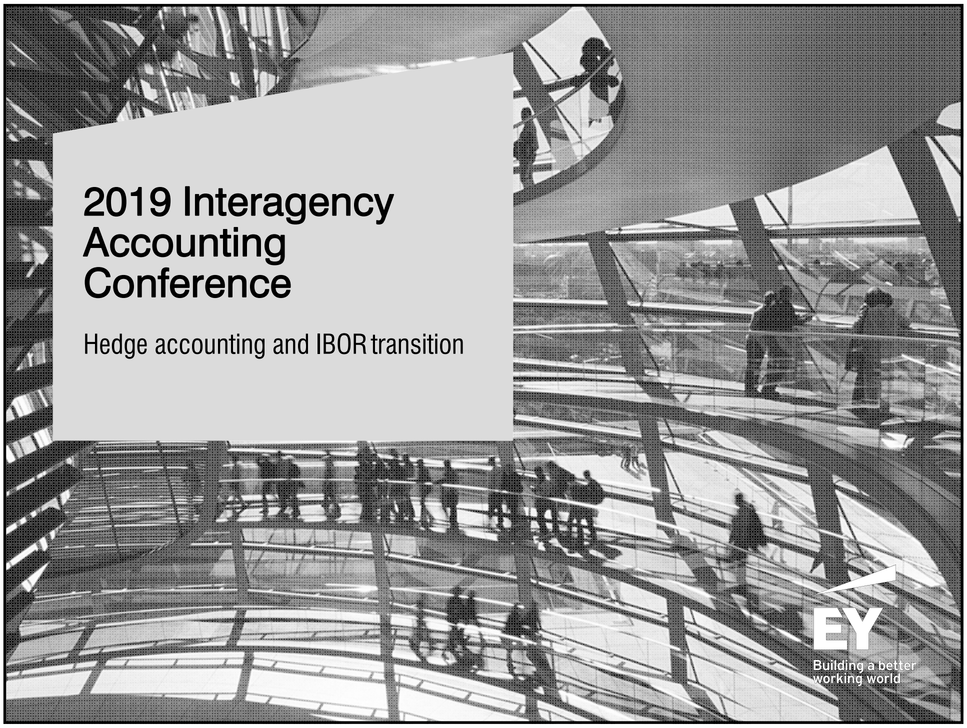

2019 Interagency Accounting Conference

Hedge accounting and IBOR transition

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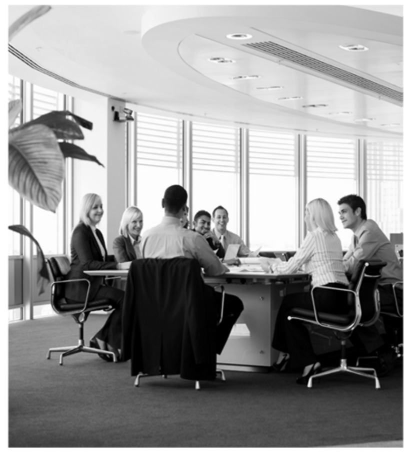
1 Hedge Accounting



Executive Summary

- The new hedge accounting standard **reduces the complexity** in applying hedge accounting while allowing for **new asset and liability hedging strategies**.
- We are seeing renewed interest from **public and non-public IDIs to expand their use of derivatives and hedge accounting for risk management** of certain classes of assets and liabilities both due to the allowance of new strategies and the reduced burden of applying hedge accounting.
- The new hedge accounting standard also introduces **new qualitative methodologies for assessing hedge effectiveness** that could increase the risks associated with applying hedge accounting.

ASU 2017-12
Overview of the Standard

On August 28, 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. (ASU) 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

The Standard was intended to:

- Portray more clearly the effects of hedge accounting on an entity's financial statements
- Reduce complexity in the hedge accounting model

The standard addresses the following concerns regarding the existing model:

- Users' difficulties in applying hedge accounting and its limitations for hedging both financial and non-financial risks
- The manner in which hedge activities are reported in the financial statements

The guidance is **effective for public business entities for fiscal years beginning after 12/15/18, including interim periods within those years**. For all other entities, it is effective for annual periods beginning after 12/15/19, and interim periods the following year. Early adoption was permitted in any interim period or fiscal year before the effective date.

The guidance also allows entities upon transition to make **a one-time election to transfer assets from held-to-maturity to available-for-sale so long as they qualify for the last-of-layer method**.

Impact of changes

ASU 2017-12 will impact companies in the following ways:

	A	B	C
	Improve existing hedge strategies	**New hedge strategy opportunities**	**New presentation and disclosure requirements**
Current criticism with ASC 815	Complexity surrounding the application of hedge accounting	Restrictions on risks that are eligible to be hedged	Users' difficulty in understanding hedging results
FASB's improvements	Simplify certain hedge documentation and assessment requirements	Address risk component hedging and certain fair value hedge strategies of interest rate risk	Introduce additional disclosures and changes to the presentation of hedge results to better align the effects of the hedging instrument with the hedged item
Impact and expected benefits	Reducing operational cost and complexity when applying hedge accounting	Aligning the financial reporting for derivatives with an entity's risk management objectives by permitting certain hedge strategies that were previously disallowed	Eliminating the need to separately measure and present hedge ineffectiveness Provide more useful disclosures and financial statement information

Snapshot of key changes

		Category		Improvements
A Improve existing hedge strategies	Business	Interest rates	1	Changed the measurement of the hedged item in a fair value hedge of the benchmark interest rate component
			2	Changed the measurement of the hedged item for fair value hedges of financial instruments with prepayment features
			3	Changed the measurement of the hedged item for a partial-term fair value hedge
		Foreign exchange	4	Relaxed requirements for critical terms match (CTM) method of assessment
			5	Allowed cross-currency basis spread as an excluded component
	Operations	Operational simplification	6	Allowed more time for the preparation of initial effectiveness testing
			7	Reduced the costs and complexity of monitoring effectiveness assessments by allowing subsequent qualitative assessments
			8	Made the shortcut method more forgiving

Snapshot of key changes

		Category		Improvements
B New hedge strategy opportunities	Business	Interest rates	9	Incorporated the last of layer method for a closed portfolio of pre-payable financial assets
			10	Permitted hedging of the contractually specified rate in variable-rate financial instruments
			11	Included SIFMA municipal swap rate as an eligible benchmark interest rate
		Commodities	12	Permitted hedging for contractually specified component of non-financial contracts
C New requirements	Compliance and disclosure		13	Permitted amortization approach for excluded components
			14	Eliminated the need to separately measure and report hedge ineffectiveness
			15	Presented entire change in fair value of a hedging instrument in the same line item as the hedged item
			16	Amended existing and introduced new disclosures to provide more meaningful information

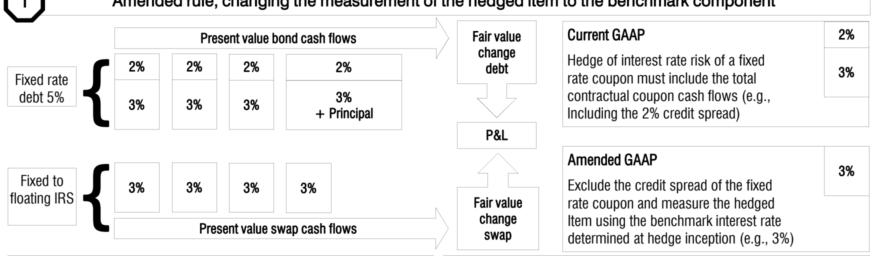
A Fair value hedge of the benchmark interest rate component

Consider the following fact pattern:

- ► An entity issues four-year 5% fixed rate debt. On the date the entity issues the debt, the LIBOR swap rate is 3% and the entity's credit spread is 2%.
- ► On the same date, the entity enters into a pay 3M-LIBOR receive fixed interest rate swap to hedge the interest rate risk on the newly issued debt instrument.
- ► The fixed rate on the swap is equal to 3%, the LIBOR swap rate on the date the entity enters into the swap.

A Fair value hedge of the benchmark interest rate component

1 Amended rule, changing the measurement of the hedged item to the benchmark component



Benefits

- As the credit spread component is no longer required to be included in the calculation of the change in fair value of the hedged item, reduces the dollar-duration gap between the derivative and the hedged item.
- By hedging only the benchmark rate component at hedge inception, companies have the potential of reducing earnings volatility for fair value hedges of interest rate risk
- Retrospective application of benchmark hedging may reverse hedge ineffectiveness incurred since hedge inception up to the date of adoption

Challenges

- Developing a valuation methodology to determine the benchmark coupon at hedge inception, potential approaches include:
  - Using the fixed rate of an at-market swap
  - Solving for the benchmark coupon using an iterative process to get back to par
- Certain sources of earnings volatility may continue to exist
- Calculate the transition adjustment

A Improve existing hedge strategies
Cross-currency basis spread (CCBS)

5 Allowed cross-currency basis spread as an excluded component (fair value and net investment hedges)

Improvements	
• The FASB decided that it would add a cross-currency basis spread to the list of allowable excluded components. • In addition, entities can now switch from the forward method to the spot method and vice versa for net investment hedges by de-designating and re-designating net investment hedge relationships.	
Business opportunities	**Challenges**
• Increased the opportunity to use cross-currency swaps in fair value hedges and net investment hedges as higher likelihood exists of qualifying for hedge accounting • Reduces volatility and smooth earnings by electing to amortize changes in the cross-currency basis spread through the income statement • Ability to switch from the forward method to the spot method and vice versa gives more flexibility for net investment hedging	• New processes to bifurcate the changes in fair value of the hedging instrument due to the impact of changes in cross-currency basis spreads • New processes to amortize the currency basis spreads through earnings • Develop new valuation methodology for hedging instruments to calculate the change in fair value of the cross currency basis spreads • Develop new accounting operations and processes • Implement/enhance derivative subledgers
People, process and technology impact	

Forex risk management	Middle office/Quants	Data and IT	Accounting	Financial reporting

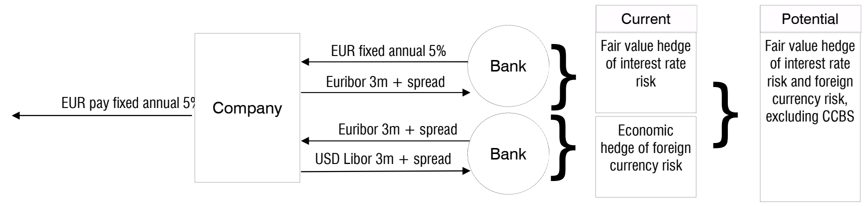
Cross-currency basis spread as excluded component in a FV hedge

Consider the following fact pattern:

- ► An entity issues a fixed rate, EUR denominated bond with principal and interest payments due annually.
- ► On the same date, the company also enters into two derivatives:
  - ► To hedge interest rate risk, the company enters into a fixed-to-float interest rate swap with a bank, where the Company receives EUR at a fixed rate of 5%, while paying 3M Euribor plus a spread. The Company applies fair value hedging to this relationship.
  - ► To hedge foreign exchange risk, the company enters into a basis swap where it receives 3M Euribor plus a spread, while paying 3M USD Libor plus a spread. The Company does not apply hedge accounting to this relationship.

Illustration of cross-currency basis spread as excluded component in a FV hedge

Amended rule, potential hedge structures



Benefits	Challenges
• Using the economic hedging for foreign currency risk may lead to earnings volatility due to changes in cross-currency basis spreads. The ability to exclude CCBS under the amended hedge accounting guidance makes a combined hedge of interest rate risk and foreign-currency risk more attractive, due to its potential of reducing earnings volatility.	• Developing a valuation methodology to determine changes in fair value of the cross-currency swap attributable to changes in cross-currency basis spread • For the hedged items and derivatives, develop a methodology to attribute changes in fair value to changes in interest rates, and changes in foreign exchange rates • Recognize changes in fair value in net interest margin, non-interest and other comprehensive income

One methodology for isolating the change in fair value attributable to CCBS is to calculate the change in fair value of the cross-currency swap (as the CCBS is only in that derivative) and eliminating the foreign exchange (FX) settlement component.

A Improve existing hedge strategies
Subsequent qualitative assessments

7 **Reduced the costs and complexity by allowing subsequent qualitative assessments (all hedges)**

Improvements

- Quantitative effectiveness testing would continue to be required at inception (unless qualified for the critical terms match, shortcut or simplified hedge accounting method).
- Entities may elect to subsequently assess hedge effectiveness on a qualitative basis, on a hedge-by-hedge basis, unless facts and circumstances change to the extent that the entity cannot qualitatively assert that the hedge was, and continues to be, highly effective.
- An entity would be able to return to qualitative assessments after a significant change in facts and circumstances required it to return to a quantitative assessment.
- The same principle and factors should be used to evaluate whether an entity could perform qualitative assessments at hedge inception and after a quantitative test has been performed subsequent to hedge inception.

Business opportunities	Challenges
• May reduce the quarterly assessment time, cost and effort by switching to qualitative assessment. • Free up or realign critical resources once qualitative criteria have been determined.	• Significant judgment may be required to design a set of criteria for qualitative assessments and/or to define "a change in facts and circumstances." • Additional effort may be required to design goal posts at the hedge inception that would form the criteria for qualitative assessments. • Additional effort may be required to assess how a non-mirrored feature could impact qualitative assessments (i.e., options).

People, process and technology impact

Accounting policies | Qualitative testing | Compliance | Quantitative testing

Reduced the costs and complexity of monitoring effectiveness assessments by allowing subsequent qualitative assessments (all hedges)

2 Last of Layer Application

Executive Summary

- ASU 2017-12 provides a new approach, called the last-of-layer method (LOL), for hedging prepayable assets (or beneficial interests) in a closed portfolio allowing entities to hedge assets that previously rarely qualified for hedge accounting.
- Accordingly, entities are able to align economic, accounting, and risk management activities.
- Upon adoption entities are able to take advantage of a one-time transition election to transfer assets that qualify for the LOL method from held-to-maturity to available-for-sale.
- We are seeing challenges in implementing the LOL method.
- The FASB is considering expanding the LOL method to allow entities to hedge multiple layers within a single closed portfolio of financial assets.

B The Last-of-Layer Method
An overview

Why the strategy was necessary

- During the public exposure process, significant industry support was gathered around simplifying the ability to hedge prepayable financial assets including on a portfolio basis
- The ability to hedge a portfolio of prepayable assets under pre-ASU guidance was not feasible due to the effect that changes in interest rates may have on the number of prepayments that will occur in the portfolio. This includes paydown of a single securitized asset's notional due to underlying asset prepayment.
- Entities generally manage interest rate risk for these types of portfolios on a segmented basis, managing its risk separately for short vs. long duration assets within portfolio.

New opportunities

Closed Portfolio	• Entities may build a closed portfolio from which to designate a last of layer hedge. • No assets may be added subsequently; however, assets may be voluntarily removed or sold.
Eligibility	• Assets must be prepayable in order to be eligible to be added to the closed portfolio. • The FASB staff have clarified that assets must be prepayable at some point during the life of the hedge for any reason other than due to credit.
Last of Layer	• Entities may designate a portion of the closed portfolio that is expected to be free from default, sales, or prepayments. • The portion designated must continually be assessed and outstanding during the life of the hedge.

The Last-of-Layer Method
Subsequent reporting periods

Unless an entity's forecast shows the last-of-layer balance has decreased, an entity would re-measure their proxy for the hedged item (typically modeled as a bullet bond with the weighted average characteristics of the hedged pool of loans) through P&L and also put the derivative through P&L.

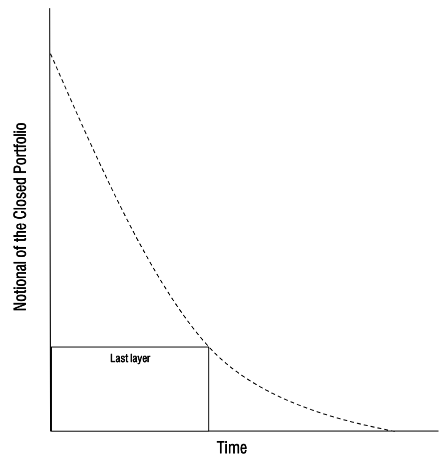
Dr.	Loan Portfolio	XXX	
Cr.	Interest Income		XXX
Dr.	Interest Income	XXX	
Cr.	Derivative Asset		XXX

Operational Considerations

- Assess the effectiveness of the hedging relationship quantitatively or qualitatively, based on the entity's accounting policy election
- Re-project the amount of the closed portfolio expected at hedge maturity
- Consider the impacts of basis adjustments and the appropriate allocation methodologies, if any

The Last-of-Layer Method
An example

Example Last of Layer Hedge under ASU 2017-12



Portfolio Notional: $20,0000,000

Underlying Assets: A portfolio of prepayable mortgage loans

Hedged Risk and Objective: To hedge the change in fair value for a specified notional portion of a closed portfolio of prepayable mortgage loans for changes in fair value due to fluctuations in the benchmark interest rate.

Last of Layer Designated: $5,000,000

Hedge Period: 5 years

Example Hedging Instrument: Received fixed, pay float interest rate swap

Similar Asset Considerations: Qualitative analysis performed due to partial term an benchmark component considerations

Last of layer method
Hedging multiple layers

The FASB Staff have recently begun their outreach with various stakeholders across industry. Numerous questions arisen regarding eligibility and operability of potential strategies.

Eligibility and Designation

Is an entity permitted to use a combination of spot and forward starting swaps to hedge "vertical" layers?

Is an entity permitted to use an amortizing swap to match the estimated prepayment speed of the closed pool?

How should qualitative similar asset testing be performed? Should such assertions be made on a pool level, individual layer level, or both?

Can additional layers be designated at any time?

Partial/Full De-Designation

What layers are partially/fully de-designated when an entity forecasts that its last of layer may breach?

If a layer is breached, will entities have to de-designate all hedging relationships for the closed portfolio or just the breached layer?

Will the Staff require sequencing of layers or may entities voluntarily choose which layers to de-designate?

Last of layer method
Accounting for basis adjustments

Basis adjustment allocation

Even for single layer hedge relationships, questions have arisen in practice as to how entities should consider fair value hedge basis adjustments with regards to their interaction with other areas of US GAAP.

The open questions pertaining to how entities should account for basis adjustments was included within the scope of FASB's project on hedging multiple layers.

Open Questions

1 Is an entity permitted to allocate basis adjustments to individual items in the closed portfolio for hedge accounting purposes before full or partial de-designation?

If yes, may an entity include the basis adjustment when determining the realized gain or loss when selling individual items in the closed pool?

2 If an entity keeps the basis adjustment at the portfolio level for hedge accounting purposes, is an entity still required to allocate basis adjustments to individual items within a pool for purposes of impairment and disclosures?

If yes, may an entity conclude that consideration of the fair value basis adjustments would be immaterial for impairment purposes?

3 Is there a prescribed methodology for allocating basis adjustments?

C New presentation and disclosure requirements

13 **Permitted amortization approach for excluded components (all hedges)**

Improvements

- The FASB has decided that the base recognition model for excluded components for cash flow, fair value, and net investment hedges would be an amortization approach and that entities would also be allowed, as an accounting policy election, to apply a mark-to-market through earnings approach.
- The election is required to be applied consistently to all similar hedging relationships and disclosed as an accounting policy election.
- Under either of these recognition approaches, amounts related to excluded components that are recorded in earnings are presented in the same income statement line item as the earnings effect of the hedged item (except for net investment hedges).
- Additionally, when a hedging relationship is discontinued and an amortization approach is used, the changes in fair value of excluded components recorded in accumulated other comprehensive income (AOCI) would be released to earnings consistent with existing generally accepted accounting principles (GAAP) for each respective type of hedging relationship.

Business opportunities	Challenges
• Reduce volatility and better align the accounting with risk management perspective by electing to amortize the excluded components through income statement • New hedging strategies may now be more palatable	• New methodology/accounting model needed for amortizing excluded components • Decision to balance income statement volatility management with operational complexity • Consistent application of accounting for excluded components across similar strategies

People, process and technology impact

Interest rate risk management | Middle office/Quants | Data and IT | Accounting | Financial reporting

③ IBOR

Executive Summary

- The transition from IBORs to alternative reference rates is introducing **risks for public and non-public IDIs that have IBOR exposure in current financial contracts given the expected phase-out of IBORs towards the end of 2021**.
- Financial institutions are in **various phases of transitioning** to alternative reference rates including performing impact assessments and developing transition plans.
- As part of these impact assessments, institutions are studying fallback language within agreements including understanding which **contracts may need to be renegotiated**.
- Transitioning to an alternative reference rate is expected to have **P&L impacts** given the fallback methodologies that have been developed, as well as **wider implications on finance and accounting including hedge accounting**.

IBOR: What is it?
IBOR definition, use and scope

Interbank Offered Rates (IBORs) impact hundreds of trillions of dollars worth of financial instruments across the globe.

IBOR definition

IBORs are average rates at which certain banks could borrow in the interbank market and range in tenors from overnight to 12 months. The rates include a spread reflecting the credit risk involved in lending money to banks.

LIBOR (London interbank offered rate): The IBOR for the London interbank market

TIBOR (Tokyo interbank offered rate): The rate offered in the Japan interbank market

EURIBOR (euro interbank offered rate): The rate offered in the euro interbank market

IBOR uses

IBORs are used by a broad range of market participants in a wide range of product types.

Broad market footprint

- **USD LIBOR and EURIBOR**
  - Approximately 80% (>$370TN) of the total IBOR market exposure
- **Derivatives (OTC derivatives and ETDs)**
  - More than $300TN (80%) of products referencing IBORs
- **The 3-month tenor by volume**
  - Most widely referenced rate in all currencies (followed by the 6-month tenor)

US market USD LIBOR reference	EURO market EURIBOR reference
97% of the $3.4TN of **syndicated loans**	90% of the $535BN of **syndicated loans**
84% of the $1.5TN of **FRNs**	70% of the $2.6TN of **FRNs**
30%-50% of the $2.9TN of **business loans**	60% of the $5.8TN of **business loans**

IBOR: Why a transition?
Benchmark reform drivers

The transition from IBORs to alternative RFRs is critical given market manipulation, false reporting, system risk, lack of liquidity and other issues which may underlie the IBORs, but is also expected to deliver additional benefits.

Drivers

The global regulatory community initiated IBOR reform to reinstate confidence in the reliability and robustness of benchmark rates. The effort to reform IBORs is driven by the following factors:

- **Charges of attempted manipulation** and false reporting
- **Systemic risk** due to the uncertainty surrounding the durability of IBORs
- **Decline in the liquidity** within the interbank unsecured funding markets
- **Reluctance** from LIBOR and EURIBOR panel banks **to submit quotes**

Background

- Wheatley review of London Inter-Bank Offer Rate (LIBOR)
- G20 asked the Financial Stability Board (FSB) to reform major interest rate benchmarks
- The Official Sector Steering Group (OSSG) was established
- International Organization of Securities Commissions (IOSCO) principles published
- The Market Participants Group (MPG) was established

- The outcome of these reviews was a recommendation to enhance existing IBORs and promote the development and adoption of alternative nearly risk-free reference rates (RFRs).
- Working Groups have convened across several jurisdictions to better understand challenges and propose alternative RFRs.
- Based on the proposals, market participants have begun mobilizing programs to assess the impacts to their organizations.

Publication of LIBOR past 2021 is not guaranteed.

2018 Global IBOR Transition Report

Summary of main findings

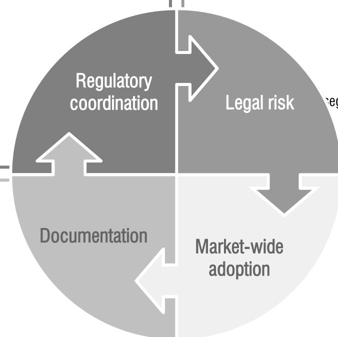
The report outlines important views from 153 market participants and provides recommendations on the importance of mobilizing efforts to understand the scale of its exposure to IBORs.

Global regulatory guidance and coordination is imperative

Further guidance on regulatory expectations of alternative RFR adoption and a globally coordinated and harmonized transition across products is critical to prevent bifurcation and significant disruption in the market.

Litigation exposure is among the biggest concerns

Institutions are concerned that the transition to alternative RFRs could lead to litigation. The transition to alternative RFRs should be safe and favorable across all market segments to avoid class action lawsuits, reputation risk and/or conduct risk.



Documentation challenges are the most concerning

Institutions are working to enhance fallback language in existing contracts to increase robustness and avoid the systemic risk of a sudden IBOR cessation. Repapering legacy contracts poses the greatest transition challenge given the sheer volume and lack of standardization in contracts, specifically for cash products.

IBORs are core to valuation and risk management models

Market-wide adoption and highly liquid volumes of derivatives referencing alternative RFRs are critical to transition. Due to the variances between IBORs and alternative RFRs an industry agreed methodology for credit spreads and term fixings is critical to minimize value transfer risk for legacy contracts.

IBOR transition background

Global alternative RFR identification

Working Groups in each jurisdiction have recommended robust, alternative reference rates to transition away from existing IBORs. The ARR benchmarks are overnight whereas current use of IBORs is largely in term rates.

Jurisdiction					
IBORs	GBP LIBOR	USD LIBOR	EURIBOR, Euro LIBOR	CHF LIBOR	JPY LIBOR, JPY TIBOR, EUROYENTIBOR
Working Group	Working Group on Sterling Risk-Free Reference Rates	Alternative Reference Rates Committee	Working Group on Euro Risk-Free Rates	The National Working Group on Swiss franc Reference Rate	Study Group on Risk-Free Reference Rates
Sub-groups	Term rates, SONIA futures, pension funds	Cash products (loans, CLOS, FRNs, mortgages, other) and outreach	Term rates, contract robustness and EONIA transition	Loan and deposit markets and capital markets and derivatives	TBC
Alternative RFR	Reformed Sterling overnight index average (SONIA)	Secured overnight financing rate (SOFR)	Euro short-term rate (ESTER)	Swiss average rate overnight (SARON)	Tokyo overnight average rate (TONA)
Description	• Unsecured • Fully transaction-based • Encompasses a robust underlying market • Overnight, nearly risk-free reference rate • Includes a volume-weighted trimmed mean	• Secured • Fully transaction-based • Robust underlying market • Overnight, nearly risk-free reference rate that correlates closely with other money market rates	• Unsecured • Fully transaction-based on data reported in accordance with the MMSR Regulation • Overnight, nearly risk-free reference rate • To be published from October 2019	• Secured • Became the reference interbank overnight repo on August 25, 2009 • Secured rate that reflects interest paid on interbank overnight repo	• Unsecured, transaction-based benchmark for the robust uncollateralized overnight call rate market • Volume-weighted average rate calculated and published daily using info. provided by money market brokers
Rate administrator	Bank of England	Federal Reserve Bank of New York	ECB	SIX Swiss Exchange	Bank of Japan
Transition plan published	No[1]	Yes	No	No	No

[1] The Working Group's preference for a potential plan has been indicated, but a plan has not been published (Source: Bank of England Official Website).

IBOR transition consequences
Top challenges our clients will face

IBORs serve as the underpinnings of a variety of products, systems and processes. As such, organizations must assess their firm-wide exposure and understand the implications of the transition across all business lines and functions.

IBORs may not continue post 2021	As new alternative RFRs are being identified across jurisdictions and products based on the emergence of new rates, organizations should prepare for a dual rate environment in the short term and plan for the possible cessation of IBORs
Reputational and litigation risk	The transition poses a high potential for reputational and litigation risk if the transition negatively impacts clients. Organizations should make sure they have necessary legal representation as part of their IBOR transition program to help monitor this risk
Market adoption and liquidity of alternative RFRs	Market adoption and liquidity in derivatives referencing alternative RFRs are needed to support the transition. As the transition timing for cash products is uncertain, organizations should prepare for the introduction of an additional basis market to hedge their exposures
Inconsistent transition dates	Inconsistent transition dates create additional complexities for cross-currency transactions. Organizations should continue to push for a globally harmonized transition but prepare for the increased cross-currency basis risk and to respond to client inquiry related to deals/products that reference multiple currencies
Select alternative RFRs may not contain a credit premium	As it is a primary focus of industry groups to drive consensus on the credit spread for each alternative RFR, organizations should develop their internal view on how the credit spread should be calculated (e.g., forward, historical mean, spot). Organizations should also run an internal impact analysis under different scenarios and begin to review their cost of funds as new products emerge

IBOR transition consequences
Top challenges our clients will face

IBORs serve as the underpinnings of a variety of products, systems and processes. As such, organizations must assess their firm-wide exposure and understand the implications of the transition across all business lines and functions.

Absence of term rate	There is a view that term rates may be required to facilitate a transition for cash products. Organizations should engage in industry groups to monitor the development of term rates for alternative RFRs
Renegotiation of client contracts	Legacy contracts that reference IBORs may need to be renegotiated to protect against the cessation of IBORs. Organizations should begin identifying contracts that would need to be renegotiated and actively engage in industry working groups to drive consensus on enhanced fallback language
Systems, data and processes	Systems, data and processes often reference IBORs. Organizations should conduct an enterprise-wide assessment on systems, data and processes to understand where IBORs and other benchmark rates are stored for downstream processing, embedded in code and/or are key components of processes
Models referencing IBORs	Models referencing IBORs will need to be enhanced, documented and reviewed. Organizations should inventory all models that use IBORs as an input and/or use historical IBOR data as a parameter and plan sufficient time for these models to be updated and validated

Finance IBOR transition "hot spots"

Impacts and considerations

Finance should be proactive and start assessing the accounting and financial reporting impacts on IBOR transition.

- 01 IBOR transition impact on products and profitability
- 02 MD&A and disclosures
- 03 Fair value
- 04 Hedge accounting
- 05 Securitization
- 06 Finance and accounting operations
- 07 Interest income and impairment
- 08 Floating rate cash instruments
- 09 Treasury
- 10 Insurance liabilities

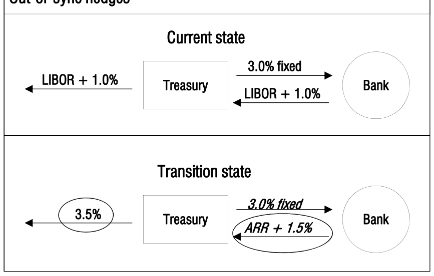
Hedge accounting

Impact on interest rate and foreign exchange hedging

04

Finance may find challenges in hedge accounting and hedging strategies when transitioning from IBOR to ARR. While the FASB is considering providing relief for hedge accounting, finance needs to evaluate its hedging relationships and impact on hedge effectiveness, alternative hedging strategies and the rebalancing of portfolios to reduce P&L volatility. As of now, the FASB has added SOFR Overnight Index Swap (OIS) as a benchmark interest rate for hedging purposes (ASU 2018-16) and added a project to consider relief provisions.

Out-of-sync hedges



Key potential impacts

1. Foreign exchange hedging impacts due to secured and unsecured ARR in different jurisdictions
2. The modification of a derivative to include an ARR may be considered a change in critical terms requiring de-designation
3. Limited availability of historical data for ARR, including discount curves, when assessing effectiveness
4. The need to update the modeling of hedged items given the change in hedged risk
5. Mismatches in timing of the hedging instrument and hedged item's transition to an ARR
6. Ability to continue to assert hedge effectiveness qualitatively when either the hedging instrument or hedged item transitions
7. The SEC has provided relief regarding asserting probable cash flows prior to transition

Finance considerations

- Inventory existing hedge accounting relationships to understand the potential impact upon transition to ARR
- Evaluate impact of basis risk on existing hedges and re-evaluate or rebalance hedging strategies
- Consider process impacts to update hedge documentation
- Are current hedge accounting processes and systems flexible enough to accommodate ARR?
- Consider alternative hedging strategies and rebalancing of portfolios to reduce P&L volatility

Floating rate cash instruments

Modification/extinguishment and embedded derivatives

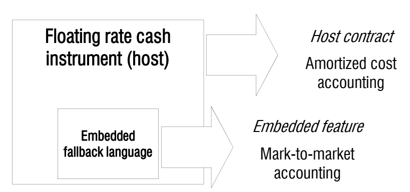
08

Finance should consider the IBOR transition impact on both new and existing IBOR floating rate cash instruments. Under ASC 815, fallback language may result in embedded derivatives that need to be considered for bifurcation. In addition, under ASC 470, an entity may need to consider whether contractual amendments result in a modification or an extinguishment.

Key potential impacts

1. Contractual amendments to include fallback language will result in an entity considering whether the instrument has been modified or extinguished.
2. Upon triggering of fallback language that results in transition to an ARR, an entity may also need to evaluate whether an instrument has been modified or extinguished.
3. For newly issued or purchased floating rate cash instruments, fallback language and the associated spread upon fallback may be an embedded derivative that requires bifurcation.
4. Mismatches between the ARR (e.g., overnight SOFR) and the interest rate reset period (e.g., monthly, quarterly) may result in embedded derivatives.

Embedded derivatives risk



Finance considerations

- Evaluate the population of existing floating rate cash products and how the fallback language may need to be amended or modified in order to incorporate an ARR in order to determine the population of instruments that may be subject to a modification/extinguishment test
- Consider whether the fallback language in newly issued or purchased floating rate cash instruments may result in embedded derivatives that need to be considered for bifurcation

Preparing for the transition

What should firms do today to prepare for a successful and harmonized transition?

As highlighted in remarks made by international regulators, RFR working group chairs and trade associations, a transition away from IBOR to alternative RFRs is exceptionally complex and therefore, all firms should proactively take action now to adequately prepare and manage the significant risks of a near future where LIBOR ceases to exist.

1	Appoint a senior IBOR program executive	• The IBOR transition program executive should be responsible for assessing, planning and coordinating the multiyear, enterprise-wide program activities. In addition, the program executive should identify business sponsors for all impacted core business lines and enterprise functions
2	Mobilize an enterprise-wide IBOR transition program	• A robust implementation plan with clear objectives, tangible milestones and work products should be established. Dedicated resources should be appointed to own and execute all project activities. Expertise in large-scale transformational initiatives and complex program management skills coupled with financial product and technical business process expertise will be necessary
3	Conduct a comprehensive impact assessment	• Develop an inventory of products to quantify your overall product exposure across IBOR-linked contracts; develop an inventory of legal contracts to assess the availability and robustness of current contract terms; and develop an inventory of all key business processes, risk models and data sources/technology applications to assess the overall infrastructure exposure
4	Offer new products linked to alternative RFRs	• Infrastructure enhancements will be required to offer new derivative and cash products linked to alternative RFRs. Some considerations include: updated contract terms, pricing, risk, operations and technology changes to support new product approval
5	Develop an inventory of contracts with long-dated exposure to IBORs	• Develop an inventory of legacy exposures and contracts that mature after 2021 (or 2019 for EONIA and Euribor). Address the risk of an ongoing exposure to IBOR, especially by amending the fallback language, and enhance risk disclosures. Where possible, minimize the IBOR exposure by moving new products to alternative RFRs

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6	Define an enterprise-wide governance framework	• Provide regular updates to the Board (or a designated sub-committee) and executive management on risks and issues; define terms of reference and membership for the steering committee; define program charter and work streams, risks and issues log, key design decisions, internal and external dependencies, communication plan and roadmap; and preliminary resource and cost estimates
7	Define a knowledge and education strategy	• The strategy should aim to heighten awareness across all internal stakeholders with respect to the firm's transition plan, the transition risks and issues and the implementation challenges
8	Define a client outreach and communication strategy	• The client outreach and communication strategy should aim to proactively engage in discussions with clients to increase awareness and education with respect to the firm's transition plan, potential transition timelines and operational mechanics of repapering and repricing, where relevant
9	Communication with the Board and executive management committee	• Communicate with the Board and executive management committee on the firm's exposures to IBOR-linked products and financial instruments, legal contracts, business processes, and technology infrastructure; the impact of IBOR transition on the firm's changing risk profile; potential impact on financial resources; program governance; transition roadmap; and business case
10	Prepare for an on-site supervisory examination	• It is anticipated that global regulators will be looking to assess the state of firm's readiness to transition away from IBORs. Firms should strengthen capabilities to respond to data requests on IBOR exposure by global regulators in a controlled environment and proactively engage and contribute to working groups facilitated by regulators and industry trade associations

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