SOFR Approved as a Hedging Benchmark Rate

The Financial Accounting Standards Board (FASB) recently added an additional benchmark rate for fair value hedging of fixed-rate securities as a first step to address the 2021 planned phaseout of the London Interbank Offered Rate (LIBOR). According to **Forbes**, more than $350 trillion in financial derivative contracts, mortgages, bonds and retail and commercial loans have their interest rates tied to LIBOR. Accounting Standards Update (ASU) 2018-16 amends the recently issued guidance in ASU 2017-12, which dramatically simplifies hedge accounting (see BKD's A Deep Dive into Hedging). These standards have the same effective date, and ASU 2018-16 would be applied on a prospective basis for qualifying new or redesignated hedging relationships entered into on or after the date of adoption, noted below.

Effective Dates ASU 2018-16 (Early adoption allowed)	Public Business Entities	All Others
	Annual and interim reporting periods beginning after December 15, 2018	Annual and interim reporting periods beginning after December 15, 2019

Indexes Eligible to Be Designated in a Hedge of Interest Rate Risk

Variable-Rate Financial Instruments	Fixed-Rate Financial Instruments
Any Contractually Specified Rate	OIS
	UST
	SIFMA
	LIBOR
	SOFR

Background

A team of federal regulators known as the Alternative Reference Rates Committee (ARRC) has been working for several years on a replacement rate for LIBOR. The team included representatives from the Federal Reserve Board, U.S. Department of the Treasury and the U.S. Commodity Futures Trading Commission. The Fed has requested that the overnight index swap (OIS) rate based on the Secured Overnight Financing Rate (SOFR) be deemed eligible as a benchmark interest rate for hedge accounting.

SOFR is a volume-weighted median spot interest rate that is published daily and calculated on the basis of overnight transactions from the prior day's trading activity in specified segments of the U.S. Treasury repo market. Similar to the Fed Funds Effective OIS rate, the OIS rate based on SOFR will be a swap rate based on the underlying overnight SOFR rate. Including the OIS rate based on SOFR as an eligible benchmark interest rate during the early stages of LIBOR marketplace transition will provide sufficient lead time for entities to prepare for changes to interest rate risk hedging strategies for both risk management and hedge accounting purposes.

ARRC is focusing on the voluntary adoption of SOFR rather than a mandated transition. SOFR will coexist with LIBOR as long as LIBOR is published, offering market participants an alternative reference rate for new transactions. Market infrastructure is slow in evolving to accommodate the end of LIBOR. The SOFR rate began being published on April 3, 2018. The Chicago Mercantile Exchange launched SOFR futures in May, and the London Clearing House recently began offering SOFR swaps clearing.

Current generally accepted accounting principles define the term benchmark interest rate based on stringent characteristics and specifically identify four permissible rates—direct Treasury obligations of the U.S. government (UST), LIBOR, the Fed Funds Effective Swap Rate (or OIS rate) and the Securities Industry and Financial Markets Association (SIFMA) municipal swap rate. FASB uses the following criteria for adding a new benchmark rate:

- Risk-free or close to risk-free
- Indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market
- Widely recognized and quoted rate in an active financial market
- Widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest rate-related transactions

FASB concluded that although the SOFR is an emerging rate, it satisfies the benchmark rate criteria.

Operational Challenges Ahead

The Wall Street Journal estimates there is $170 trillion in outstanding LIBOR-based swap contracts, of which a third are set to mature after the 2021 transition date. LIBOR also is referenced in several trillion dollars of corporate loans, floating-rate mortgages, floating-rate notes and securitized products. In addition, LIBOR is used extensively across a range of business processes, accounting, valuations and financial modeling.

Although the adoption of SOFR is voluntary, the risk of discontinuation of LIBOR after the end of 2021 makes it essential that market participants consider moving to alternative rates and have appropriate fallback language in existing contracts referencing LIBOR. Fallback language refers to the legal provisions in a contract that apply if the underlying reference rate in the product is discontinued or unavailable. The current fallback language only addresses a temporary cessation of LIBOR, *i.e.*, computer glitches, and would not be workable if LIBOR ceases to be published. The derivative industry trade group, the International Swaps and Derivatives Association (ISDA), is leading a project to develop standardized fallback language. This only will apply to derivative contracts and not cash products like loans, bonds and securitizations; however, ARRC is working on language for cash products.

Assuming market participants accept the new SOFR rates, removing and replacing LIBOR will be complicated with the biggest effect on long-dated contracts with a maturity after the 2021 LIBOR phaseout. For derivative contracts, master agreements between counterparties will have to be amended or replaced. Retail mortgages, home equity lines of credit and any other consumer or business debt tied to LIBOR will have to be amended unless a backup interest rate index is referenced in the original documentation. Mortgage-backed securities, loans and floating-rate bonds all tied to LIBOR will have to be addressed contractually and—with regard to deal-specific covenants—may require consents from the owners of these securities.

FASB will monitor the development of SOFR term rates in the marketplace. In addition, FASB has added a project to address the operational challenges of migrating to a new benchmark rate. Relief will be needed from the requirement to dedesignate an existing hedging relationship and redesignate a new hedging relationship as a result of a change in any of the critical terms. A change in either the fallback provision or the contractual variable rate of LIBOR-based contracts would be considered a change in the critical terms of the hedging relationship, indicating a dedesignation would be required.

Effective Date & Transition

For entities that have not already adopted ASU 2017-12, the amendments in ASU 2018-16 are required to be adopted concurrently with ASU 2017-12. For public business entities that already have adopted ASU 2017-12, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For all other entities that already have adopted ASU 2017-12, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Early adoption is permitted in any interim period immediately if an entity already has adopted ASU 2017-12. The amendments should be adopted on a prospective basis for qualifying new or redesignated hedging relationships entered into on or after the date of adoption.

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