FINANCIAL ACCOUNTING SERIES

FASB ACCOUNTING STANDARDS UPDATE

No. 2018-16
October 2018

Derivatives and Hedging (Topic 815)

Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

The *FASB Accounting Standards Codification*® is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

For additional copies of this Accounting Standards Update and information on applicable prices and discount rates contact:

Order Department
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Please ask for our Product Code No. ASU2018-16.

FINANCIAL ACCOUNTING SERIES (ISSN 0885-9051) is published monthly with the exception of May and October by the Financial Accounting Foundation, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. Periodicals postage paid at Norwalk, CT and at additional mailing offices. The full subscription rate is $283 per year. POSTMASTER: Send address changes to Financial Accounting Series, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. | **No. 475**

FASB Accounting Standards Update

No. 2018-16
October 2018

Derivatives and Hedging (Topic 815)

Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

Accounting Standards Update 2018-16

Derivatives and Hedging (Topic 815)

Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes

October 2018

CONTENTS

Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

Topic 815, Derivatives and Hedging, provides guidance on the risks associated with financial assets or liabilities that are permitted to be hedged. Among those risks is the risk of changes in fair values or cash flows of existing or forecasted issuances or purchases of fixed-rate financial assets or liabilities attributable to the designated benchmark interest rate (referred to as interest rate risk). At present in the United States, eligible benchmark interest rates are the interest rates on direct Treasury obligations of the U.S. government (UST), the London Interbank Offered Rate (LIBOR) swap rate, and the Overnight Index Swap (OIS) Rate based on the Fed Funds Effective Rate. Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, introduced the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate as the fourth permissible U.S. benchmark rate.

Because of concerns about the sustainability of LIBOR, the Federal Reserve Board and the Federal Reserve Bank of New York (Fed) initiated an effort to introduce an alternative reference rate in the United States. In 2014, the Fed convened the Alternative Reference Rates Committee (ARRC), made up of a consortium of major financial institutions and other market participants, to identify a suitable alternative to the U.S. dollar (USD) LIBOR that is more firmly based on actual transactions in a robust market. In 2017, the ARRC identified a broad Treasury repurchase agreement (repo) financing rate referred to as the Secured Overnight Financing Rate (SOFR) as its preferred alternative reference rate, and the Fed began publishing that daily rate on April 3, 2018. SOFR is a volume-weighted median interest rate that is calculated daily based on overnight transactions from the prior day's trading activity in specified segments of the U.S. Treasury repo market.

During the hedge accounting project that led to the issuance of Update 2017-12*,* the Fed requested that the OIS rate based on SOFR be considered eligible as a U.S. benchmark interest rate for purposes of applying hedge accounting under Topic 815. Similar to the OIS rate based on the Fed Funds Effective Rate, which is a swap rate based on the underlying overnight Fed Funds Effective Rate, the OIS rate based on SOFR will be a swap rate based on the underlying overnight SOFR rate. The Fed and ARRC expressed the importance of including the OIS rate based on SOFR as a benchmark rate for hedge accounting purposes in facilitating broader use of the underlying SOFR rate in the marketplace.

Who Is Affected by the Amendments in This Update?

The amendments in this Update apply to all entities that elect to apply hedge accounting to benchmark interest rate hedges under Topic 815.

What Are the Main Provisions?

The amendments in this Update permit use of the OIS rate based on SOFR as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815 in addition to the UST, the LIBOR swap rate, the OIS rate based on the Fed Funds Effective Rate, and the SIFMA Municipal Swap Rate.

How Do the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

The amendments in this Update permit the OIS rate based on SOFR as a U.S. benchmark interest rate. Including the OIS rate based on SOFR as an eligible benchmark interest rate during the early stages of the marketplace transition will facilitate the LIBOR to SOFR transition and provide sufficient lead time for entities to prepare for changes to interest rate risk hedging strategies for both risk management and hedge accounting purposes.

When Will the Amendments Be Effective?

For entities that have not already adopted Update 2017-12, the amendments in this Update are required to be adopted concurrently with the amendments in Update 2017-12.

For public business entities that already have adopted the amendments in Update 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 the amendments in Update 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 upon issuance of this Update if an entity already has adopted Update 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.

Amendments to the *FASB Accounting Standards Codification*®

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–9. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is <u>underlined</u>, and deleted text is ~~struck out~~.

Amendments to Master Glossary

2. Add the new Master Glossary term *Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate,* with a link to transition paragraph 815-20-65-4, as follows: **[Note: The definitions of *Benchmark Interest Rate* and *Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate* are shown for convenience.]**

<u>**Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate**</u>

<u>The fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Secured Overnight Financing Rate (SOFR) (an overnight rate) with no additional spread over SOFR on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the variable cash flows.</u>

Benchmark Interest Rate

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

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

Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate

The fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index with no additional spread over the SIFMA Municipal Swap Index on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the variable cash flows.

3. Amend the following Master Glossary terms, with a link to transition paragraph 815-20-65-4, as follows:

Fed Funds Effective Rate Overnight Index Swap Rate ~~(or Overnight Index Swap Rate)~~

The fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Fed Funds Effective Rate (an overnight rate) ~~effective rate~~ with no additional spread over the Fed Funds effective rate on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the variable cash flows.

LIBOR Swap Rate

See London Interbank Offered Rate (LIBOR) Swap Rate.

London Interbank Offered Rate (LIBOR) Swap Rate

The fixed rate on a single-currency, constant-notional interest rate swap that has its variable-rate leg referenced to the London Interbank Offered Rate (LIBOR) with no additional spread over LIBOR on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equate to the present value of the variable cash flows.

Amendments to Subtopic 815-20

4. Amend paragraph 815-20-25-6A, with a link to transition paragraph 815-20-65-4, as follows:

Derivatives and Hedging—Hedging—General

Recognition

> > > Hedged Items Involving Interest Rate Risk

815-20-25-6 Hedges involving a **benchmark interest rate** are addressed in paragraphs 815-20-25-12(f) and 815-20-25-12A (for fair value hedges) and paragraph 815-20-25-15(j) (for cash flow hedges). Hedges involving a contractually specified interest rate are addressed in paragraph 815-20-25-15(j) (for cash flow hedges). The benchmark interest rate or the contractually specified interest rate being hedged in a hedge of **interest rate risk** shall be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Paragraphs 815-20-25-19A through 25-19B provide guidance on the interest rate risk designation of hedges of forecasted issuances or purchases of debt instruments. An entity shall not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a **prepayable** instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the overall fair value of that prepayment option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an **embedded derivative** of the same risk class shall be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option shall be considered in designating a hedge of interest rate risk.

> > > > Benchmark Interest Rate

815-20-25-6A In the United States, the interest rates on direct Treasury obligations of the U.S. government, the **{add glossary link}**London Interbank Offered Rate (LIBOR) swap rate**{add glossary link}**, the **Fed Funds Effective <u>Rate Overnight Index</u> Swap Rate**~~ (also referred to as the Overnight Index Swap Rate)~~, ~~and~~ the **Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate**<u>, and the **Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate**</u> are considered to be benchmark interest rates. In each financial market, generally only the most widely used and quoted rates may be considered benchmark interest rates.

5. Add paragraph 815-20-65-4 and its related heading as follows:

<u>**> Transition Related to Accounting Standards Update No. 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes***</u>

<u>**815-20-65-4** The following represents the transition and effective date information related to Accounting Standards Update No. 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes:*</u>

<u>a. An entity that has not adopted the pending content that links to</u>

paragraph 815-20-65-3 shall adopt the pending content that links to this paragraph at the same time that it adopts the pending content that links to paragraph 815-20-65-3.

1. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is required if an entity early adopts the pending content that links to paragraph 815-20-65-3.

b. An entity that has adopted the pending content that links to paragraph 815-20-65-3 shall adopt the pending content that links to this paragraph as follows:
   1. For **public business entities**, the pending content that links to this paragraph shall be effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.
   2. For all other entities, the pending content that links to this paragraph shall be effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.
   3. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is permitted.

c. The pending content that links to this paragraph shall be adopted prospectively for qualifying new or redesignated hedging relationships entered into on or after the date of adoption.

Amendments to Status Sections

6. Amend paragraph 815-10-00-1, by adding the following items to the table, as follows:

815-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	**Action**	**Accounting Standards Update**	**Date**
London Interbank Offered Rate (LIBOR) Swap Rate	Added	2018-16	10/25/2018
London Interbank Offered Rate Swap Rate	Superseded	2018-16	10/25/2018

7. Amend paragraph 815-20-00-1, by adding the following items to the table, as follows:

815-20-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	**Action**	**Accounting Standards Update**	**Date**
Fed Funds Effective Rate Overnight Index Swap Rate	Added	2018-16	10/25/2018
Fed Funds Effective Swap Rate (or Overnight Index Swap Rate)	Superseded	2018-16	10/25/2018
LIBOR Swap Rate	Amended	2018-16	10/25/2018
London Interbank Offered Rate (LIBOR) Swap Rate	Added	2018-16	10/25/2018
London Interbank Offered Rate Swap Rate	Superseded	2018-16	10/25/2018
Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate	Added	2018-16	10/25/2018
815-20-25-6A	Amended	2018-16	10/25/2018
815-20-65-4	Added	2018-16	10/25/2018

8. Amend paragraph 815-25-00-1, by adding the following items to the table, as follows:

815-25-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	**Action**	**Accounting Standards Update**	**Date**
London Interbank Offered Rate (LIBOR) Swap Rate	Added	2018-16	10/25/2018
London Interbank Offered Rate Swap Rate	Superseded	2018-16	10/25/2018

9. Amend paragraph 815-30-00-1, by adding the following items to the table, as follows:

815-30-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	**Action**	**Accounting Standards Update**	**Date**
London Interbank Offered Rate (LIBOR) Swap Rate	Added	2018-16	10/25/2018
London Interbank Offered Rate Swap Rate	Superseded	2018-16	10/25/2018

The amendments in this Update were adopted by the unanimous vote of the six members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Gary R. Buesser
Marsha L. Hunt
R. Harold Schroeder

Background Information and Basis for Conclusions

BC1. The following summarizes the Board's considerations in reaching the conclusions in this Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

BC2. Topic 815 permits a bifurcation-by-risk approach for hedges of financial assets and liabilities. Among the risks permitted to be hedged is the risk of changes in fair values or cash flows of existing or forecasted fixed-rate financial assets or liabilities attributable to the designated benchmark interest rate (referred to as interest rate risk). For simplicity, the stated interest rate in a financial asset or liability can be characterized as containing two components—a risk-free rate and a credit spread. The concept of the benchmark interest rate attributes any credit spread associated with a specific borrower to credit risk rather than interest rate risk. In permitting hedges of benchmark interest rate risk, the Board provided a practical means to designate the risk of changes in the hedged item attributable to changes in the risk-free component of the interest rate in isolation, without requiring that an entity also hedge changes in the spread above the benchmark interest component (which is deemed to reflect credit risk).

BC3. Initially, in the United States, for hedge accounting purposes only the interest rates on direct Treasury obligations of the U.S. government (UST) and, for practical reasons, the London Interbank Offered Rate (LIBOR) swap rate were considered benchmark interest rates. In 2013, the FASB issued Accounting Standards Update No. 2013-10, *Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes*, which added the Overnight Index Swap (OIS) rate based on the Fed Funds Effective Rate as a third benchmark rate in the United States. Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, introduced the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate as the fourth permissible U.S. benchmark rate.

BC4. When the LIBOR swap rate was first permitted as a benchmark interest rate for hedging purposes, LIBOR was observed to be the most widely referenced rate in derivative instruments and also was used as a reference rate in certain nonderivative financial instruments, such as some variable-rate loans. LIBOR continues to be the most commonly used reference rate. However, concerns about the sustainability of LIBOR have led to an effort to identify an alternative reference rate that is more firmly based on actual transactions in a robust market.

BC5. The Financial Stability Board (FSB) and the Financial Stability Oversight Council indicated that the decline in wholesale unsecured short-term funding by banks, especially since the financial crisis, poses structural risks for unsecured benchmarks based on interbank offer rates. They also indicated that because U.S. dollar (USD) LIBOR is used in such a large volume and broad range of financial products and contracts, the risks surrounding it pose a potential threat to the safety and soundness of individual financial institutions and to U.S. financial stability. Consequently, in November 2014, with support from several agencies including the U.S. Department of the Treasury, the U.S. Commodity Futures Trading Commission, and the Office of Financial Research, the Federal Reserve Board and the Federal Reserve Bank of New York (Fed) convened the Alternative Reference Rates Committee (ARRC) to identify a suitable alternative to USD LIBOR and to create an adoption plan with means to facilitate the acceptance and use of one or more alternative reference rates.

BC6. In 2017, the ARRC announced that it had identified a broad Treasury repo financing rate as its preferred alternative reference rate. The rate is referred to as the Secured Overnight Financing Rate (SOFR). The Fed began publishing the daily SOFR rate on April 3, 2018, and the ARRC has announced a transition plan for its integration into the financial markets. SOFR is calculated by the Fed on the basis of a specific methodology applied to a pre-defined set of repo transactions. That set includes transactions from the prior day's trading activity in specified segments of the U.S. Treasury repo market that are overnight or that are open transactions that reset daily. The ARRC's transition plan assumes that liquidity will first be established in short-term derivative instruments referencing SOFR followed by the use of SOFR by central counterparties as a discount rate. The Board understands that the objective of the transition plan is to gradually increase the duration of derivatives based on SOFR to create liquidity in contracts with longer term maturities.

BC7. During the hedge accounting project that led to the issuance of Update 2017-12, the Fed requested that the OIS rate based on SOFR be considered eligible as a U.S. benchmark interest rate for purposes of applying hedge accounting under Topic 815. This rate would be determined in a manner similar to other benchmark rates in Topic 815, such as the Fed Funds Effective Rate Overnight Index Swap Rate and the LIBOR swap rate, which are derived from their underlying published rates of the Fed Funds Effective Rate and LIBOR, respectively. In support of its request, the Fed indicated that including the OIS rate based on SOFR as a benchmark rate for hedging purposes would be an important step toward acceptance of the new SOFR rate in the marketplace.

BC8. In paragraph BC77 of Update 2017-12, the Board acknowledged this issue:

> The Board acknowledges the Federal Reserve's initiative and the importance that emerging benchmark rates have in the marketplace. Therefore, the Board is prepared to add to the list of eligible benchmark rates as necessary when those rates emerge. The Board understands that the ARRC has identified its preferred alternative reference rate and is prepared to add a project to its agenda to consider adding that rate to the list of eligible benchmark rates when the Board and the Federal Reserve deem it appropriate. The Board observed that its decision to add the OIS rate in 2013 exemplified that the current standard-setting process enabled the Board to use judgment in considering the relevant aspects of that rate, including its emerging importance in the marketplace. The Board notes that there was no impediment to resolving that issue in a timely manner.

BC9. The Board issued a proposed Accounting Standards Update on February 20, 2018, and received 21 comments letters on the proposed Update. Overall, respondents supported the amendments in the proposed Update, but many respondents also suggested expanding the scope of the guidance as discussed further in the next sections.

Basis for Conclusions

BC10. The proposed Update discussed in paragraph BC9 added the OIS rate based on SOFR to the list of eligible benchmark interest rates in the United States. In reaching this decision, the Board acknowledges that OIS contracts based on SOFR are not yet widely traded in the U.S. financial markets. Nonetheless, the Board decided to propose that the OIS rate based on SOFR should be added as a benchmark interest rate for several reasons.

BC11. The Board considered the circumstances surrounding the Fed's request to add the OIS rate based on SOFR as a benchmark rate for hedge accounting purposes before the rate is present in swap contracts. The Board recognizes the underlying reasons for the effort undertaken to identify an alternative reference rate as discussed in paragraph BC5 and understands that there is widespread support for the ARRC's transition plan to integrate the underlying SOFR rate into the U.S. financial markets. The Board also is aware of the effect of the substantial changes occurring in the marketplace on hedging activities and the importance of adding the OIS rate based on SOFR for hedge accounting purposes in facilitating transition from LIBOR to SOFR.

BC12. In considering whether a new benchmark interest rate should be added for hedge accounting purposes, the Board assessed whether the future OIS rate based on SOFR would be expected to meet the characteristics of a benchmark rate in GAAP. The Master Glossary of the Codification defines the term *benchmark interest rate* as follows:

> A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions.
>
> In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate.

BC13. Although the OIS rate based on SOFR is an emerging rate, the Board believes that it would satisfy the characteristics of a benchmark rate according to the Master Glossary definition based on an assessment of the attributes of the repo transaction rates supporting the SOFR rate (and the OIS rate based on SOFR), which reflect the financing rates on overnight repo transactions secured by U.S. Treasury securities. From a credit risk perspective, overnight repo transactions collateralized by U.S. Treasury securities, which are regarded as among the highest quality securities in the financial system, are nearly risk free. The Board also observes that the repo transaction rates supporting the SOFR rate (and the OIS rate based on SOFR) are widely recognized and quoted in the Treasury repo market, which is larger than the Fed Funds market that underlies the OIS rate based on the Fed Funds Effective Rate. Therefore, in the Board's view, when considered from the perspective of the underlying rates, the characteristics of a benchmark rate are satisfied.

BC14. This is different from the Board's approach when it added LIBOR as a benchmark rate. At that time, the Board considered the characteristics referenced in the Master Glossary definition of benchmark interest rate mainly on the basis of the volume of derivative instruments referencing LIBOR, rather than the volume of underlying market-based transactions that support that rate. Given market evolution, the Board believes that it is compelling to evaluate those characteristics by focusing on the depth of the market for the underlying overnight Treasury repo transactions that support the OIS rate based on SOFR.

BC15. While the OIS rate based on SOFR may not immediately meet the characteristics of widely recognized, quoted, and referenced given the lack of derivative transactions referencing that rate, this is similar to the situation that existed when the Board added the OIS rate based on the Fed Funds Effective Rate as a benchmark rate. At that time, as stated in paragraph BC8 of Update 2013-10, the OIS rate based on the Fed Funds Effective Rate was "evolving as a widely recognized and quoted rate" and "becoming more widely used in the U.S. financial market as an underlying basis for determining the interest rates of certain individual financial instruments." Since the rate was added in 2013, the Board notes that available data indicate that there has been an increase in the volume of overnight index swaps based on the Fed Funds Effective Rate. The Board believes that it is reasonable to expect a similar development for derivatives based on the underlying SOFR rate.

BC16. The Board also notes that the benchmark rate concept in GAAP is meant to incorporate some flexibility into the guidance to allow the addition or the subtraction of benchmark interest rates if changes in the financial markets indicate that such a change is warranted. For the reasons discussed, the Board believes that the circumstances surrounding the introduction of the underlying SOFR rate into the marketplace warrant the addition of the OIS rate based on SOFR as a new U.S. benchmark rate for hedge accounting purposes at the current time. The Board understands that the ARRC's transition plan also includes the planned introduction of a term rate based on derivatives referencing the underlying SOFR rates that reflects common borrowing intervals for cash instruments in 2021. The Board decided to limit its proposal to adding the narrow OIS rate based on SOFR (rather than a swap rate that contemplates SOFR-indexed borrowings with tenors greater than overnight) because the ARRC's transition plan currently anticipates introducing just OIS swaps based on SOFR in the marketplace in the near term. An OIS is a specific type of interest rate swap in which the floating-rate reference index is an overnight rate, while a broader swap can have a floating leg based on any tenor, including tenors longer than overnight. In an OIS contract, parties agree to swap a floating interest rate based on an average of the overnight index rate in exchange for a fixed interest rate. The Board solicited feedback on whether to permit a more generic swap rate based on SOFR that would be comparable to the LIBOR swap rate.

BC17. In feedback on the proposed Update, stakeholders generally supported adding the OIS rate based on SOFR as a U.S. benchmark interest rate. A majority of respondents also supported a broader swap rate that would include a SOFR term rate, noting that this inclusion would further facilitate the development and acceptance of the SOFR term rate in the marketplace. Some respondents noted that this would avoid future standard setting when SOFR term rates become widely used.

BC18. In redeliberations, the Board decided to confirm its decision to add only the OIS rate based on SOFR as a benchmark rate in GAAP for hedge accounting purposes. The Board concluded that a swap rate based on a SOFR term rate does not at present meet the characteristics of a benchmark interest rate for several reasons. First, unlike a SOFR OIS swap that has a floating leg referencing the overnight SOFR rate based on actual overnight repo transactions, a SOFR swap that has a floating leg referencing a SOFR term rate would not be based on actual term repo transactions. Second, neither derivative nor cash instruments referencing a SOFR term rate exist. And, third, the Board observes the uncertainty about development of a swap rate based on a SOFR term rate given the FSB's recent statement that indicated that more limited use of term rates would be compatible with financial stability. Therefore, the Board concluded that it would be premature to include the rate as a benchmark rate as part of the amendments in this Update. The Board plans to monitor the development of SOFR term rates in the marketplace and is prepared to consider a SOFR term rate when that rate emerges in the marketplace. The Board notes that the LIBOR swap rate continues to be an eligible benchmark rate.

Effects of LIBOR to SOFR Transition

BC19. The proposed Update included a question in the Questions for Respondents about whether relief is necessary for existing hedging relationships based on LIBOR that will transition to SOFR or newly designated hedging relationships based on SOFR. Most of the respondents indicated that relief is 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 that a dedesignation would be required.

BC20. The Board understands that there are potential issues that likely will need to be addressed with respect to existing hedging relationships because of a market-wide transition from LIBOR to SOFR. Therefore, the Board considered whether relief provisions for existing hedging relationships that will be affected by the market-wide transition from LIBOR to SOFR could be incorporated into this Update. However, based on its research and limited outreach with stakeholders, the Board concluded that additional time is needed to fully consider all implications of the transition of existing LIBOR-based financial instruments to SOFR and the specific hedge accounting issues that should be addressed. For example, the Board understands that the ARRC and the International Swaps and Derivatives Association (ISDA) are working on improving fallback provisions for LIBOR-based contracts and believes that it would benefit from understanding the final outcome of that effort. As a result, the Board decided to limit the scope of the amendments in this Update to newly designated hedging relationships based on SOFR and add to its agenda a project to consider relief provisions for existing hedging relationships because it did not want to delay an entity's ability to apply hedge accounting for new hedging relationships based on SOFR.

BC21. The Board also understands that the LIBOR to SOFR transition may affect other areas of financial instrument accounting beyond hedge accounting. Therefore, the Board decided to consider more broadly within that project's scope those changes to GAAP necessitated by the market-wide transition from LIBOR to SOFR, with the objective of facilitating the LIBOR to SOFR transition.

Transition and Disclosures

BC22. The Board proposed that the potential guidance including a new benchmark rate could be applied only on a prospective basis for qualifying new or redesignated hedging relationships entered into on or after the date of adoption. As a practical matter, the Board believes that this guidance would be issued contemporaneously with the emergence of OIS contracts based on SOFR. Furthermore, retrospective application would be contrary to the hedge documentation requirements. The Board also proposed no additional recurring disclosures because it believes that those disclosures are unnecessary for the addition of a new benchmark rate. This is consistent with the approach taken for past additions of new benchmark rates in the United States.

BC23. Respondents generally supported the proposed amendments related to transition and disclosures, and the Board confirmed those amendments.

Effective Date

BC24. The proposed Update requested feedback on whether the effective date of this Update should align with the effective date of Update 2017-12. Respondents generally supported the alignment and also suggested that the Board allow early adoption of this Update in any interim period after its issuance, regardless of an entity's decision on adopting Update 2017-12.

BC25. Based on the feedback on the proposed Update, and because Update 2017-12 limits the designation of benchmark interest rate risk as the hedged risk to certain hedging relationships, the Board concluded that the effective dates of this Update should coincide with the effective dates of Update 2017-12 for entities that have not adopted Update 2017-12. Specifically, the Board observed that Update 2017-12 limits benchmark interest rate risk hedging only to hedges of fixed-rate instruments and forecasted purchases or issuances of debt instruments if it is uncertain at the inception of the hedging relationship whether the instrument to be issued will be fixed rate or variable rate. The Board concluded that the same applicability should be required for the amendments in this Update. Therefore, the Board concluded that the amendments in this Update should be adopted concurrently with the amendments in Update 2017-12 for entities that have not already adopted Update 2017-12.

BC26. For public business entities that already have adopted Update 2017-12, the Board decided that the amendments should be effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For other entities that already have adopted Update 2017-12, the Board decided that the amendments should be effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. The Board intended to provide other entities that adopt the amendments in Update 2017-12 in an interim period with additional time to implement the amendments in this Update when compared with other entities that adopt the amendments in Update 2017-12 in an annual period. For other entities that adopt the amendments in this Update in an interim period, the Board decided that the additional time would be unnecessary because of this Update's limited scope. Additionally, the Board decided to permit early adoption in any interim period upon issuance of the Update if an entity already has adopted Update 2017-12.

Benefits and Costs

BC27. The Board believes that the addition of the OIS rate based on SOFR as an eligible benchmark rate in GAAP on a timely basis will eliminate some of the uncertainty that potentially could hamper market acceptance of the new underlying SOFR rate and, therefore, facilitate the LIBOR to SOFR transition. In addition, it will assist entities in planning to change hedging strategies after the new rate is introduced. Adding the OIS rate based on SOFR as a benchmark rate is intended to help preparers that will designate OIS swaps based on SOFR as hedging instruments by aligning the cash flows and discount rates used to measure the change in fair value of the hedging instrument and the hedged item and, therefore, to appropriately depict risk management strategies. In addition, the OIS rate based on SOFR may qualify for hedge accounting under IFRS 9, *Financial Instruments,* because IFRS 9 allows both a separately identifiable and a reliably measurable component of the financial instrument to be designated as the hedged risk. Furthermore, the Board believes that because the OIS rate based on SOFR will be more firmly based on actual market transactions in a robust market, this rate has the potential to more appropriately represent and faithfully reflect a risk-free rate than other presently permitted benchmark rates. Thus, its permitted use will be more consistent with the original intent of allowing benchmark rate hedging.

BC28. The Board does not anticipate that entities will incur significant costs as a result of the amendments in this Update. The Board notes that because hedge accounting is elective, not all reporting entities will bear the costs of the amendments. Therefore, any additional costs apply only to those entities that elect to apply hedge accounting. Therefore, the Board concluded that the expected benefits of the amendments in this Update justify the expected costs.

Amendments to the XBRL Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update require improvements to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). Those improvements, which will be incorporated into the proposed 2019 Taxonomy, are available through Taxonomy Improvements provided at www.fasb.org, and finalized as part of the annual release process.