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REFERENCE RATE REFORM

Executive Summary

- Contributing panel banks to the London Interbank Offered Rate (LIBOR) will no longer be compelled to supply information to this benchmark rate after 2021.
- LIBOR will likely cease publication post 2021; however, publication might continue. continuation post 2021 is subject to quality of information risk and regulatory risk.
- Financial markets are in search of suitable replacement reference rates.
- The Alternative Reference Rates Committee (ARRC) in the United States has recommended the Secured Overnight Financing Rate (SOFR) as an alternative to LIBOR.
- LIBOR-based contracts must be analyzed for reference rate risk if existing contracts extend beyond 2021 or are currently being negotiated with a LIBOR reference.
- The Financial Accounting Standards Board (FASB) has added the SOFR to the list of hedge-eligible interest rates by way of Accounting Standards Update (ASU) 2018-16 Derivatives and Hedging (Topic 815), Inclusion of the Secured Overnight Financial Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes.
- The Financial Accounting Standards Board has issued a proposed ASU (PASU) to provide relief beyond hedging contracts as a result of LIBOR discontinuance. This includes relief for leases, receivables, debt, and embedded derivatives.

Timeline and History

The Financial Stability Board (FSB), an international body that monitors and makes recommendations about the global financial system[1], released its report, Reforming Major Interest Rate Benchmarks, in July 2014. In that report, the FSB highlighted the risks associated with several major benchmark interest rates that are used in the financial markets. One of the factors leading to this investigation was the susceptibility of these reference rates to manipulation, specifically the 2012 LIBOR scandal which resulted in significant fines and reputational damage to certain investment banks. The realization that widely used reference rates can be manipulated has given way to reference rate reform and the search for alternative reference rates.

The FSB report stresses that "a benchmark rate can only be as robust as its underlying market[2]," and that there has been a noticeable decline in the underlying market activity that is the basis for LIBOR and other IBOR based rates. The FSB did not endorse any specific alternative reference rates; rather, it champions a multiple-rate approach to strengthen the existing IBOR based rates.

The Financial Conduct Authority, a United Kingdom financial regulator, is charged with oversight of LIBOR since 2013, following the 2012 LIBOR scandal. In a July 2017 presentation to Bloomberg, Andrew Bailey, FCA Chief Executive, outlined plans for the discontinuance of LIBOR. Approximately 20 panel banks contribute to the LIBOR benchmark, and submissions to the benchmark are highly scrutinized and require tight controls. Mr. Bailey highlighted aspects of the FSB's concern over the apparent dwindling linkage of the LIBOR reference rate to actual unsecured wholesale term lending activity among banks. In the absence of this interbank lending activity, LIBOR has been more and more supported by expert judgment exercised by the submitting panel banks.

Panel banks have expressed uneasiness in contributing to the benchmark when estimation and judgment prevails over actual transactional activity. Despite this uneasiness, the FCA is charged with compelling the panel banks to contribute to the benchmark in order to preserve the stability of the rate. Should one or more panel banks discontinue their submissions, the quality of LIBOR would be jeopardized, potentially leading to a market disruption. Mr. Bailey also highlighted the disparity between the current use of LIBOR references in corporate lending and in mortgages, in which he saw little to no correlation between the use of the reference rate and the financing transactions, postulating that LIBOR's use was either because, (1) other lenders use LIBOR or (2) other alternative references are less established and less liquid.[3]

FCA and the contributing panel banks have agreed to sustain LIBOR through the end of 2021, at which point the panel banks will no longer be compelled to contribute to the benchmark. This should allow sufficient time for the financial markets to find an acceptable alternative reference rate. Mr. Bailey acknowledged that LIBOR could continue post 2021, but it will no longer be regulated.

As recent as July 15, 2019, Andrew Bailey gave an update on LIBOR transition progress.[4] Several jurisdictional alternative reference rate committees such as the United States ARRC and the United Kingdom's Risk Free Rate Working Group (RFRWG) have investigated alternative reference rate options and made recommendations. The RFRWG is recommending the Sterling Over Night Index Average while the ARRC is recommending the SOFR. Both are considered to be risk-free rates. Mr. Bailey strongly reiterated that with wide sweeping interest in new risk-free rates, the survival of LIBOR is unlikely and that panel bank departures are almost certainly expected post 2021. With the departure of panel banks, it will be challenging for the rate to pass regulatory tests. Mr. Bailey urged those who have not weighed the risks of LIBOR-based contracts that extend past 2021 or who are currently negotiating LIBOR-based contracts to do so immediately.

The Securities and Exchange Commission (SEC) staff issued a statement in July 2019 updating the transition away from LIBOR which included the views of the SEC Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, and Office of the Chief Accountant. These SEC Divisions examined risk identification and risk mitigation associated with the transition from LIBOR to alternative reference rates.[5] The SEC staff statement emphasizes the risks to the financial markets if an alternative reference rate is not widely adopted by the anticipated LIBOR discontinuance date. At this time, the SEC does not endorse any alternative reference rate and it is monitoring market participants' recommendations, including the ARRC and other jurisdictional alternative reference rate committees. The SEC staff statement highlights several points to consider in regards to existing LIBOR based contracts including:[6]

- the effect of LIBOR discontinuation on the operation and integrity of the contract;
- the absence of LIBOR fallback provisions or fallback provisions that do not consider the permanent discontinuance of LIBOR;
- acceptable alternative reference rates that might replace LIBOR in existing contract fallback provisions or during contract renegotiations;
- whether alternative reference rates should be further adjusted to achieve the intended economic impact of the contract;
- whether the discontinuance of LIBOR will impact the effectiveness assessment of hedging relationships; and
- new risks associated with adopting alternative reference rates.

New contracts currently being negotiated to reference LIBOR should include fall-back provisions if those contracts are anticipated to extend beyond 2021. The ARRC has published recommended fallback language for new LIBOR based contracts which can be found at the following link: https://www.newyorkfed.org/arrc/fall-backs-contract-language. Additionally, the International Swaps and Derivatives Association (ISDA) has been developing fallback language for ISDA based contracts and can be found at the following link: https://www.isda.org/2019/05/16/isda-publishes-two-consultations-on-benchmark-fallbacks/.

The SEC Divisions referred to above each weighed in on the impact of discontinuance with a focus on the necessity of certain disclosures for registrants. We at Schneider Downs believe that non-registrants would also benefit from examining these considerations from a risk management standpoint rather than from a disclosure standpoint, which is why we excerpted the bullet points below from the SEC Division of Corporation of Finance. Chiefly among this Division's concerns regarding transition is the importance of disclosures of timely, comprehensive and accurate information about material events and risks that would be important to an investor. Related to the discontinuance of LIBOR, companies are encouraged to consider the significance and relevance of disclosures surrounding:

- the evaluation and mitigation of risks related to the expected discontinuation of LIBOR and the effect of the discontinuation potentially spanning multiple reporting periods;
- when a material exposure to LIBOR has been identified, but quantification of the exposure is not reasonably estimable; and
- how transitioning from LIBOR to an alternative rate may impact the company, including qualitative and quantitative disclosures comparing contracts under LIBOR versus those same contracts under an alternative rate.

The SEC Office of the Chief Accountant identified several financial reporting and accounting matters that are likely affected by the transition away from LIBOR and has tasked standard setting bodies, namely the FASB, to address these issues including[7]:

- modifications of terms within debt instruments;
- hedging activities;
- inputs used in valuation models; and
- potential income tax consequences.

Secured Overnight Financing Rate

In 2017, the ARRC identified the SOFR as the preferred rate for derivative and other financial contracts. Citing its depth, liquidity and market activity, ARRC believes that SOFR is much more resilient and relevant than LIBOR. SOFR is a measure of the cost of borrowing cash overnight, collateralized by U.S. Treasury securities, and is based on directly observable U.S. Treasury-backed repurchase transactions. Starting in April 2018, SOFR is published each business day at 8:00 AM by the Federal Reserve Bank of New York.[8] With daily volumes in excess of $800 billion, far exceeding any other U.S money market, these transactions offer a broader representation of market participants and thus, ARRC is far more protected from manipulation. ARRC introduced a Paced Transition Plan in 2017 and recently released a set of 2019 Incremental Objectives to supplement the Paced Transition Plan.[9]

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

The FASB issued ASU 2018-16 in October 2018. ASU 2018-16 was issued in response to ARRC's recommendation of the SOFR and to stakeholder concerns raised regarding the sustainability of LIBOR in light of the apparent lack of actual underlying transactions used by panel banks to support LIBOR. The Federal Reserve Board had recommended to the FASB that in conjunction with the formation of ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities, FASB should also adopt the OIS rate, which is based on SOFR to be a hedge accounting eligible interest rate. This amendment affects entities that elect to apply hedge accounting to benchmark interest rates. The amendment may only be adopted if ASU 2017-12 has been adopted. The amendments in ASU 2018-16 are effective for fiscal years beginning after December 15, 2018 for public business entities that have already adopted the provisions of ASU 2017-

12 and for fiscal years beginning after December 15, 2019 for all other entities that have already adopted the provisions of ASU 2017-12. This ASU requires prospective application.[10]

ASU 2018-16 amends the Master Glossary and includes the following definition for the SOFR 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 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.[11]"

In situations where the effectiveness of a hedge is measured by the alignment of its critical terms, we believe that without this transition relief, many hedging relationships would no longer be effective upon the discontinuance of LIBOR and the inclusion of SOFR. When the critical terms no longer align as originally documented at hedge inception, hedging relationships must be discontinued, leading to earnings volatility and incremental costs to amend the hedging relationship.

2019 Proposed Accounting Standards Update

In response to stakeholders' concerns and in light of the issues raised by the aforementioned SEC staff statement, on September 5, 2019 the FASB issued an exposure draft for a Proposed Accounting Standards Update (PASU) covering reference rate reform and the facilitation of the effects of transitioning away from IBORs to new reference rates. This proposal offers temporary optional guidance for contract modifications and hedging relationships affected by the transition away from LIBOR. The relief offered by this proposal would only be available through December 31, 2022.[12]

The effect of reference rate transition over the next few years is likely going to trigger contract modifications where current guidance suggests that a new contract is required to be established for accounting purposes. The introduction of an alternative reference rate should not change the original intended economic outcome of the contract nor should the contracting parties be penalized as a result of these reforms. Stakeholders have said that the added burden and costs of accounting for these modifications as new contracts rather than as an extension of existing contracts is unnecessary and that is why this PASU has been drafted. Stakeholders also revisited prior concerns about the potential for dedesignation of hedging status when reference rates are changed in a contract in this PASU.[13]

The following is a direct excerpt from the PASU.

"The proposed guidance would provide the following optional expedients that reduce costs and complexity of accounting for reference rate reform:[14]

1. Simplify accounting analyses under current GAAP for contract modifications if qualifying criteria are met:
   a. Modifications of loans, debt, and other financial instruments would be accounted for by prospectively adjusting the effective interest rate.

   b. Lease modifications would be accounted for as a continuation of the existing contract with no reassessments or remeasurements.
   c. Modifications of contracts would not require a reassessment of whether an embedded derivative should be accounted for as a separate instrument.
   d. Modifications of contracts for which explicit guidance is not proposed would also be accounted for as a continuation of those contracts with no reassessments of previous determinations.
2. Allow hedging relationships to continue without dedesignation upon the following changes in the critical terms of an existing hedging relationship due to reference rate reform:
   a. A change in the critical terms of a designated hedging instrument in a fair value, cash flow, or net investment hedge.
   b. A change to rebalance or adjust the hedging relationship.
   c. For a cash flow hedge, a change in the method used to assess hedge effectiveness when initially applying an optional expedient method and when reverting to the requirements under current GAAP.
3. Provide optional expedients for existing fair value hedging relationships for which the derivative designated as the hedging instrument is affected by reference rate reform:
   a. An entity may change the designated benchmark rate to a different eligible benchmark rate.
   b. An entity that applied the shortcut method of accounting may continue to apply that method for the remainder of the hedging relationship.
4. Provide temporary optional expedients for cash flow hedging relationships affected by reference rate reform:
   a. If the designated hedged risk is a rate that is affected by reference rate reform, an entity would disregard the potential change in the designated hedged risk that may occur due to reference rate reform when the entity assesses whether the hedged forecasted transaction is probable and an entity may continue hedge accounting for an existing cash flow hedge for which the hedged risk changes if either the hedge is highly effective or an optional expedient method is elected.
   b. For existing cash flow hedges for which the shortcut method or another method that assumes perfect hedge effectiveness is applied, entities would be permitted to continue to apply that method.
   c. For new cash flow hedges for which either the hedging instrument or hedged forecasted transactions would reference a rate that is expected to be affected by reference rate reform, entities would be permitted to adjust the application of the methods used to initially assess whether cash flow hedge accounting may be applied to disregard the mismatch in variable interest rate indexes between the designated hedging instrument and the hedged item.
   d. For new cash flow hedges of portfolios of forecasted transactions that reference a rate that is expected to be affected by reference rate reform, an entity may disregard the requirement that the group of individual transactions share the same risk exposure for which they are designated as being hedged.

e. For both existing and new cash flow hedges, entities may adjust the application of the methods used to subsequently assess whether cash flow hedge accounting may be applied to disregard the mismatch in variable interest rate indexes between the designated hedging instrument and the hedged item due to reference rate reform. Alternatively, an entity may elect an optional expedient to continue cash flow hedge accounting if certain qualitative criteria are met each period, effectively suspending subsequent cash flow hedge effectiveness assessments."

Endnotes

1 "About the FSB", n.d., accessed September 15, 2019, https://www.fsb.org/about

2 "Reforming Major Interest Rate Benchmarks: Progress Report", November 14, 2018, https://www.fsb.org/2018/11/reforming-major-interest-rate-benchmarks-progress-report/

3 "Speech by Andrew Bailey, Chief Executive of the FCA, at Bloomberg London", July 27, 2017, https://www.fca.org.uk/news/speeches/the-future-of-libor.

4 "LIBOR: Preparing for the End", July 15, 2019, https://www.fca.org.uk/news/speeches/libor-preparing-end.

5 "Staff Statement on LIBOR Transition", July 12, 2019, https://www.sec.gov/news/public-statement/libor-transition.

6 "Staff Statement on LIBOR Transition", July 12, 2019, https://www.sec.gov/news/public-statement/libor-transition.

7 "Staff Statement on LIBOR Transition", July 12, 2019, https://www.sec.gov/news/public-statement/libor-transition.

8 "Secured Overnight Financing Rate Data", n.d., accessed September 15, 2019, https://apps.newyorkfed.org/markets/autorates/sofr.

9 "Transition from LIBOR", n.d., accessed September 15, 2019, https://www.newyorkfed.org/arrc/sofr-transition.

10 "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 2019, https://www.fasb.org/

11 "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 2019, https://www.fasb.org/

12 "Proposed Accounting Standards Update—Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting", September 5, 2019, https://www.fasb.org/

13 "Proposed Accounting Standards Update—Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting", September 5, 2019, https://www.fasb.org/

14 "Proposed Accounting Standards Update—Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting", September 5, 2019, https://www.fasb.org/

Our Thoughts On

We cannot over-emphasize the importance of examining existing LIBOR based contracts that extend beyond 2021 and evaluating the risks and risk mitigation strategies. Communication with lenders and contract counterparties is crucial to develop a LIBOR transition plan. Holding these conversations now will help to mitigate the risk associated with the discontinuance of LIBOR and will lessen the costs to renegotiate contracts. Examining the intended economic purpose of an original LIBOR based contract including modeling the intended economic outcome will assist both parties in creating or amending fall-back provisions or adopting an entirely new reference rate. We continue to monitor the latest developments in the topic of alternative reference rates and stand ready to assist in evaluating the impacts of these reforms for you and your company.

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