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To the Point

FASB — final guidance

Companies can use a new benchmark interest rate for hedge accounting

Permitting OIS as a benchmark interest rate will likely increase demand for OIS-based financial products.

What you need to know

- The FASB issued final guidance allowing companies to designate the Federal Funds Effective Swap Rate (which is the Overnight Index Swap rate, or OIS rate, in the US) as a benchmark interest rate for hedge accounting purposes.
- Companies can use the rate to develop new hedging strategies, but the new guidance will not resolve ineffectiveness issues that arise in existing LIBOR hedges when the OIS rate is used to discount future cash flows.
- The guidance is effective immediately.

Overview

The Financial Accounting Standards Board (FASB or Board) today issued final guidance[1] permitting the Federal Funds Effective Swap Rate (which is the Overnight Index Swap rate, or OIS rate, in the US) to be designated as a benchmark interest rate for hedge accounting purposes under ASC 815.

Previously, the hedge accounting rules in US GAAP allowed only US Treasury and London Interbank Offered Rate (LIBOR) rates to be used as benchmark interest rates. With the new guidance, the FASB is responding to an increase in demand for hedging exposures to the OIS rate caused by changes in the marketplace, including regulations that are increasingly requiring collateralization and central clearing of over-the-counter derivatives.

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Background

Market participants began using an interest rate curve based on OIS rates rather than LIBOR to value the future cash flows of collateralized derivatives during the financial crisis. At the time, concerns about the health of banks and other financial institutions drove LIBOR much higher than other interest rates with similar tenors and increased volatility.

Bank credit and liquidity risks are reflected in LIBOR because that rate reflects the average cost to banks for borrowing funds unsecured from each other in the London interbank market for up to one year. By contrast, the Federal Funds Effective Rate is the weighted average of the rates at which US depository institutions lend overnight to each other using funds held at the US Federal Reserve.

Growth in the use of OIS is continuing because of regulations around the world requiring more derivatives to be collateralized. The FASB, in fact, moved quickly on the recommendation of its Emerging Issues Task Force because rules requiring certain over-the-counter derivatives to be centrally cleared and therefore collateralized are being phased in this year. The rules were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Using OIS, rather than LIBOR, to value a derivative's future cash flows aligns the discount curve with the rates used to calculate interest paid on cash collateral posted for derivative obligations. Many market participants believe this is appropriate because OIS discounting reflects the lower cost of financing a collateralized derivative. (See our Technical Line, *FASB proposes new US benchmark interest rate for hedging*, for more information about the growing use of OIS.)

Key considerations

Companies can designate the Fed Funds Effective Swap Rate as a benchmark interest rate on a prospective basis in new or redesignated hedging relationships as of the date the final guidance was issued (17July 2013). Existing interest rate swaps designated as benchmark interest rate hedges must be redesignated in new hedge relationships with new hedge documentation if a company wants to change the hedged risk to the OIS rate.

The FASB also eliminated the restriction in ASC 815-20-25-6 on designating different benchmark interest rate hedges for "similar hedges." During the comment letter process, some respondents expressed concerns that a risk manager may have valid reasons to hedge different benchmark interest rates in what may appear to be similar hedging relationships.

ASC 815 requires extensive quantitative and qualitative disclosures about derivatives and hedging relationships but does not require companies to disclose the specific interest rate benchmark that is hedged. Therefore, the new guidance does not require additional disclosures.

How we see it

Companies can now swap their fixed-rate debt for OIS (rather than LIBOR) and avoid the ineffectiveness issues they currently experience with collateralized LIBOR interest rate swaps.

We expect the removal of the guidance in ASC 815-20-25-6 that "the use of different benchmark interest rates for similar hedges shall be rare and shall be justified" to eliminate any diversity in practice resulting from different interpretations of the term "similar hedges."

Endnote:

[1] 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 (a consensus of the FASB Emerging Issues Task Force)*