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No. 2013-10
July 2013

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

An Amendment of the *FASB Accounting Standards Codification®*

Financial Accounting Standards Board

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CONTENTS

Page Numbers

Summary 1–2
Amendments to the *FASB Accounting Standards Codification*® 3–5
Background Information and Basis for Conclusions 6–9
Amendments to the XBRL Taxonomy 10

Summary

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

Topic 815, Derivatives and Hedging, provides guidance on the risks that are permitted to be hedged in a fair value or cash flow hedge. Among those risks for financial assets and financial liabilities is the risk of changes in a hedged item's fair value or a hedged transaction's cash flows attributable to changes in the designated benchmark interest rate (referred to as interest rate risk). In the United States, currently 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 are considered benchmark interest rates.

As a result of the financial crisis in 2008, the exposure to and the demand for hedging the Fed Funds rate have increased significantly. That demand has been driven by an increased focus by banks on their sources of funding (including an increased focus on overnight interbank borrowings of surplus balances held at the Federal Reserve), the greater (and sometimes volatile) spread between LIBOR and OIS ("Overnight Index Swap Rate" or also referred to as the "Fed Funds Effective Swap Rate"), and new regulatory measures to curb systemic risks (such as increased collateralization of derivatives). Considering the increased importance of OIS, the objective of this Update is to provide for the inclusion of the Fed Funds Effective Swap Rate (OIS) as a U.S. benchmark interest rate for hedge accounting purposes, in addition to UST and LIBOR.

Who Is Affected by the Amendments in This Update?

The amendments apply to all entities that elect to apply hedge accounting of the benchmark interest rate under Topic 815.

What Are the Main Provisions?

The amendments in this Update permit the Fed Funds Effective Swap Rate (OIS) to be used as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to UST and LIBOR. The amendments also remove the restriction on using different benchmark rates for similar hedges.

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

Before the amendments in this Update, only UST and, for practical reasons, the LIBOR swap rate were considered benchmark interest rates in the United States under Topic 815. Including the Fed Funds Effective Swap Rate (OIS) as an acceptable U.S. benchmark interest rate in addition to UST and LIBOR will provide risk managers with a more comprehensive spectrum of interest rate resets to utilize as the designated benchmark interest rate risk component under the hedge accounting guidance in Topic 815.

When Will the Amendments Be Effective?

The amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013.

How Do the Provisions Compare with International Financial Reporting Standards (IFRS)?

Under IFRS, a hedge of interest rate risk is not explicitly limited to specified benchmark interest rates but, rather, is described in terms of a rate that is both a separately identifiable component of a financial instrument and reliably measurable.

Amendments to the *FASB Accounting Standards Codification*®

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–5. 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 underlined, and deleted text is ~~struck out~~.

Amendments to Master Glossary

2. Add the following new term *Fed Funds Effective Swap Rate (or Overnight Index Swap Rate)* to the Master Glossary, with a link to transition paragraph 815-20-65-1, as follows: **[Note: The definitions of Benchmark Interest Rate and London Interbank Offered Rate Swap Rate are shown for convenience.]**

Fed Funds Effective 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 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.

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.

London Interbank Offered Rate 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

3. Amend paragraphs 815-20-25-6 through 25-6A, with a link to transition paragraph 815-20-65-1, as follows:

Derivatives and Hedging—Hedging—General

Recognition

> > > Hedged Items Involving Interest Rate Risk

815-20-25-6 Hedges involving the benchmark interest rate are addressed in paragraph 815-20-25-12(f) (for fair value hedges) and paragraph 815-20-25-15(j) (for cash flow hedges). The **benchmark 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. ~~Ordinarily, an entity shall designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraphs 815-20-25-80 through 25-81. The use of different benchmark interest rates for similar hedges shall be rare and shall be justified.~~ 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, currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the London Interbank Offered Rate (LIBOR) swap rate and the **Fed Funds Effective Swap Rate** (also referred to as the Overnight Index Swap Rate) are considered to be benchmark interest rates. In each financial market, generally only the one or two most widely used and quoted rates that meet these criteria may be considered benchmark interest rates. The ~~Fed Funds rate, the~~ Prime rate, the Federal National Mortgage Association (FNMA or Fannie Mae) Par Mortgage rate, and the Securities Industry and Financial Markets Association Municipal

Swap Index (formerly called the Bond Market Association index) shall not be used as the benchmark interest rate in the United States.

4. Add paragraph 815-20-65-1 and its related heading as follows:

> Transition Related to 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*

815-20-65-1 The following represents the transition and effective date information related to 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. The pending content that links to this paragraph shall be effective on July 17, 2013.
b. The pending content that links to this paragraph shall be applied prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013.

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

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

Paragraph Number	**Action**	**Accounting Standards Update**	**Date**
Fed Funds Effective Swap Rate	Added	2013-10	07/17/2013
815-20-25-6	Amended	2013-10	07/17/2013
815-20-25-6A	Amended	2013-10	07/17/2013
815-20-65-1	Added	2013-10	07/17/2013

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

Leslie F. Seidman, *Chairman*
Daryl E. Buck
Russell G. Golden
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

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

Background Information

BC2. Topic 815 provides that among the risks permitted to be hedged for financial assets and financial liabilities is the risk of changes in a hedged item's fair value or a hedged transaction's cash flows attributable to changes in the designated benchmark interest rate (referred to as interest rate risk).

BC3. 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. In permitting the hedge of the benchmark interest rate risk in Topic 815, the Board was providing 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 (that is, benchmark interest rate risk, which, in theory, is the risk-free component) in isolation, without requiring that an entity also hedge changes in the spread (which is deemed to reflect credit risk) above the benchmark interest component. In the United States, 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 are currently considered benchmark interest rates.

BC4. During its deliberations at the time of issuing the derivatives and hedging guidance, the Board considered whether other rates in the U.S. financial markets, such as the Fed Funds rate, should be included in the definition of benchmark interest rate. At the time, the Board rejected the Fed Funds rate as a benchmark rate in the United States and decided that allowing more than two benchmark rates (that is, UST and LIBOR) to define interest rate risk was unnecessary and would make the resulting financial statements more difficult to understand. Therefore, before the issuance of this Update, use of other such indexes in the United States as the benchmark interest rate was not permitted.

BC5. The Fed Funds rate is the interest rate at which depository institutions (for example, banks) actively trade balances held at the Federal Reserve with each other, usually overnight. Institutions with surplus balances in their accounts lend those balances to institutions in need of larger balances. The weighted average of this rate across all such transactions on any given day is the daily Fed Funds effective rate. The related Fed Funds Effective Swap Rate (which represents the Overnight Index Swap Rate or OIS in the United States) is the fixed rate swapped in exchange for a floating overnight rate, which is the Fed Funds effective rate. Thus, in the United States, the relationship between the Fed Funds effective rate and the Fed Funds Effective Swap Rate (OIS) is the same as the relationship between LIBOR and the London Interbank Offered Rate Swap Rate (as defined in the Master Glossary).

BC6. As a result of the financial crisis in 2008, the exposure to OIS and the demand for hedging the Fed Funds rate have increased significantly. That demand has been driven by an increased focus by banks on their sources of funding (including an increased focus on overnight interbank borrowings of surplus balances held at the Federal Reserve), the greater (and sometimes volatile) spread between LIBOR and OIS, and new regulatory measures to curb systemic risks such as U.S. legislation that requires greater clearing of derivatives through exchanges or clearinghouses (which must be collateralized).

BC7. The increased prevalence of OIS in the marketplace can also be seen in derivatives valuation, where practice is evolving such that some believe that the appropriate discount rate to use in the valuation of collateralized derivatives should be based on OIS because that rate reflects the lower cost of financing a collateralized instrument. This has caused derivative counterparties to be more exposed to overnight rates even on derivatives whose cash flows are based on LIBOR resets and has resulted in incremental ineffectiveness in certain hedging relationships. However, the Task Force understands that the accounting guidance that prohibited OIS from being a benchmark interest rate was inhibiting entities that desire to utilize more OIS-based derivative products for risk management purposes.

BC8. The Task Force concluded that at the time of issuing the derivatives and hedging guidance, the Board intended to incorporate some flexibility into the guidance to allow addition or removal of benchmark interest rates if circumstances changed. When the Board decided to focus on UST and LIBOR as the only acceptable benchmark interest rates during its deliberations at the time of issuing the derivatives and hedging guidance, the use of OIS-based transactions was not as prevalent as it is today. However, because the exposure to and importance of OIS have increased significantly, the Task Force concluded that OIS should be an acceptable U.S. benchmark interest rate for hedge accounting purposes and that OIS meets the criteria to be a benchmark rate. OIS is indicative of high-quality borrowing rates and the extent of the credit risk associated with OIS rates is low because OIS is derived from an overnight transfer of funds rate, which inherently limits credit risk exposure. Furthermore,

OIS is evolving as a widely recognized and quoted rate that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in the U.S. market. It is a rate that is becoming more widely used in the U.S. financial market as an underlying basis for determining the interest rates of certain individual financial instruments, including collateralized derivatives, and the underlying Fed Funds rate is commonly referenced in interest-rate-related transactions as the rate at which depository institutions (for example, banks) actively trade balances held at the Federal Reserve with each other.

BC9. The Board issued a proposed Accounting Standards Update on February 21, 2013, with a comment period that ended on April 22, 2013, and received 22 comment letters on the proposed Update. Comment letter respondents overwhelmingly agreed that the OIS should be added as a U.S. benchmark interest rate. Many respondents expressed concern about the guidance in paragraph 815-20-25-6, which provides that, ordinarily, an entity shall designate the same benchmark interest rate as the risk being hedged for similar hedges and that the use of different benchmark interest rates for similar hedges shall be rare and shall be justified. Those comment letter respondents indicated that a risk manager may have valid reasons to hedge using different benchmark interest rates what may appear to be similar hedging relationships. They observed that interest rate risk may differ for a similar financial asset, financial liability, or forecasted transaction depending on how that hedged item is used within the organization and the risk manager's objective in hedging its respective interest rate risk. Consistent with the comment letter feedback and considering that no potential abuse could be anticipated, the Task Force decided to remove the restriction on using different benchmark rates for similar hedges from paragraph 815-20-25-6.

BC10. The Task Force concluded that additional recurring disclosures should not be required as a result of this guidance. Topic 815 requires extensive quantitative and qualitative disclosures about derivatives and hedging activities primarily based on underlying risk and accounting designation; however, it does not require that an entity specifically disclose the actual interest rate benchmark (for example, UST or LIBOR) that is hedged. The Task Force concluded that it is not necessary to revisit the Board's previous conclusions as to the granularity of disclosures about derivatives and hedging activities.

Transition

BC11. To qualify for hedge accounting, which is optional, Topic 815 requires formal designation and documentation of the hedging relationship before hedge accounting may be applied. Because retrospective application would be contrary to the contemporaneous hedge documentation requirements, the Task Force decided that the amendments in this Update can only be applied prospectively for qualifying new or redesignated hedging relationships entered into on or after the date of adoption. Considering both the increased exposure and importance of

OIS, the Task Force decided that the amendments in this Update should become effective immediately upon issuance.

Benefits and Costs

BC12. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Task Force's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC13. The Task Force does not anticipate that entities will incur significant costs as a result of the amendments in this Update. The amendments will provide for a more comprehensive spectrum of interest rate resets to utilize as the designated benchmark interest rate risk component under the hedge accounting guidance in Topic 815.

Amendments to the XBRL Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update require changes to the U.S. GAAP Financial Reporting Taxonomy (UGT). Those changes, which will be incorporated into the proposed 2014 UGT, are available for public comment at www.fasb.org, and finalized as part of the annual release process starting in September 2013.