

April 20, 2020

Sagar S. Teotia  
SEC Chief Accountant  
Office of the Chief Accountant  
US Securities and Exchange Commission  
Accounting Interpretations via email  
OCARrequest@sec.gov

RE: Embedded derivative accounting considerations in connection with the market transition of certain instruments from LIBOR to SOFR

CC: Financial Accounting Standards Board

### **Executive Summary**

The Alternative Reference Rates Committee Accounting and Tax subgroup (ARRC subgroup) has evaluated certain embedded derivative accounting issues associated with the Secured Overnight Financing Rate (SOFR) interest-rate reset features proposed or endorsed by the Alternative Reference Rates Committee (ARRC) for floating-rate non-derivative instruments in (1) commercial markets, such as syndicated and bilateral business loans, securitizations and floating-rate notes and (2) consumer markets, such as adjustable-rate residential mortgage (ARM) loans. The ARRC subgroup is requesting that the SEC not object to our interpretation that such debt instruments do not contain an embedded derivative as a result of inclusion of the SOFR interest rate reset features proposed or endorsed by the ARRC and will not require bifurcation from the host contract and separate accounting as a derivative under FASB ASC Topic 815, Derivatives and Hedging. While this pre-clearance submission is focused on products evaluated in the paper, the ARRC subgroup recognizes market participants may use the principles outlined in this paper to analyze embedded derivative accounting implications associated with future developments in or changes to interest rate features across various floating-rate cash products in connection with reference rate reform.

### **Background**

The ARRC finalized in 2019 its fallback language recommendations that address SOFR interest-rate reset features related to commercial products and closed-end residential ARM loans. The ARRC has not yet finalized similar recommendations for other consumer products (e.g., credit cards, student loans, etc.). Unlike the fallback language for commercial products, the fallback language for residential ARM loans does not identify an interest rate index, rather provides for the use of an index recommended by the ARRC. The ARRC expects to recommend a spread-adjusted SOFR-based index for use in consumer products, including residential ARM loans, at a future date. Additionally, the ARRC issued on July 15, 2019 a whitepaper proposing an interest rate model for new SOFR-based ARM products.

The ARRC supports industry development of new SOFR ARM products including the Fannie Mae and Freddie Mac (collectively, the government-sponsored entities or GSEs) November 15, 2019 announcement to offer new SOFR ARM products based upon the ARRC whitepaper. On February 5, 2020, the GSEs announced (1) new closed-end residential ARMs originated June 1, 2020 or after must include the ARRC-proposed fallback language to be eligible for purchase by the GSEs, (2) they will cease purchasing LIBOR ARMs by December 31, 2020, (3) further details of SOFR ARM product offerings and that (4) they anticipate to begin accepting deliveries of SOFR ARM loans in the 2<sup>nd</sup> half of 2020. Accordingly, the ARRC expects SOFR ARM products based on the ARRC whitepaper to become the standard commercial and consumer ARM products used in the industry.

For consumer products, this paper evaluates embedded derivative accounting considerations based upon proposals put forth to date, which solely relate to residential ARM loans. Finalization of interest rate reset features for

residential SOFR-based ARM products and additional proposals for other consumer products are expected at a future date. The ARRC subgroup believes the principles outlined in this paper can be applied to analyze embedded derivative accounting implications associated with future developments in or changes to SOFR-based interest rate features across various products. In the event there are unique interpretative accounting matters not previously addressed, the ARRC subgroup will seek concurrence or relief, if necessary.

The embedded derivative evaluation in this paper applies to cash instruments indexed to SOFR, as well as cash instruments indexed to LIBOR that include ARRC-recommended SOFR interest rate reset features as the contractual fallback rates in the event of a LIBOR cessation. Hence, for the latter category of instruments, upon a future event triggering the switch from LIBOR to SOFR, further embedded derivative evaluation is unnecessary as the possible SOFR interest rate reset features were already evaluated in this paper.

**Accounting Guidance**

ASC 815, Derivatives and Hedging, provides the guidance for assessing whether contractual features embedded in debt instruments, including interest rate reset features, require bifurcation and separate accounting as derivative instruments. Separate derivative accounting is required if the debt instrument is not remeasured at fair value with changes in fair value recognized in earnings and the embedded feature (1) is not “clearly and closely related” to the debt host contract (i.e., not economically similar) and (2) would otherwise require recognition as a derivative, if a freestanding contractual instrument. An interest rate or index is considered to be economically similar to a debt host instrument, provided a significant leverage factor is not involved. The FASB defines significant leverage in this context through application of a “double-double test”. Significant leverage is present if there are possible interest rate scenarios (without regard to probability of occurrence) in which the embedded derivative has the potential to both (1) double the investor’s initial rate of return and (2) at the same time double the investor’s current market return, relative to that of the debt host contract . However, ASC 815 does not provide detailed guidance to determine the terms of the host that inform the initial and market rate of return that is the basis for this analysis and, therefore, judgment is required.

**Proposal**

The paper evaluates the three SOFR interest rates recommended by the ARRC for commercial products, which are term SOFR, compounded SOFR “in-arrears” and compounded SOFR “in-advance”. The paper also evaluates the interest rate model proposed by the ARRC for SOFR-based residential ARM loans, which is consistent with the SOFR ARM product offerings announced by the GSEs. The following table summarizes these SOFR interest rate features and conclusions reached by the ARRC subgroup as to whether separate derivative accounting is required:

SOFR Rate (a)	Commercial or Consumer Products	Summary Description of Rate	Derivative Accounting Required?
Term SOFR	Commercial	Pays interest based upon a published forward-looking term SOFR for the corresponding tenor (b)	No
Compounded SOFR In Arrears	Commercial	Pays interest based upon a daily compounded average of SOFR for the corresponding tenor (b) implemented <i>in arrears</i> .	No
Compounded SOFR In Advance	Commercial	Pays interest based upon a daily compounded average of SOFR for the corresponding tenor (b) implemented <i>in advance</i> .	No
Average SOFR In Advance	Consumer or Multi-Family ARM loans	Pays interest based upon a daily simple or compounded average of SOFR implemented <i>in advance</i> . The tenor of the SOFR rate may not match the reset frequency (c).	No

(a) On March 2, 2020, the Federal Reserve Bank of New York, as administrator of SOFR, began publishing 30-, 90- and 180-day compounded average daily SOFR rates and a SOFR index. These average rates, which are backward-looking, are published daily and represent the trailing 30-, 90- and

180-average daily SOFR rates (based on calendar days) with the most recent SOFR value from the day prior to publication. It is anticipated these published rates will be used to calculate the interest payment for debt instruments referenced to the SOFR rates in this table, except for Term SOFR.

(b) “Corresponding tenor” means a period equivalent to the LIBOR rate tenor for that instrument (e.g., products indexed to 1-month LIBOR that reset monthly will become indexed to 1-month SOFR reset monthly).

(c) For example, in its whitepaper the ARRC proposed use of a 30- or 90-day average SOFR rate that resets every six months. The February 2020 announcement by the GSEs stated SOFR ARM products would use a 30 day average SOFR reset every six months and reset 45 days in advance of the interest payment date change. Currently, LIBOR ARMs are typically indexed to 1-year LIBOR term rate that resets annually.

The ARRC subgroup believes the evaluation for term SOFR and compounded SOFR in arrears is straightforward and requires little judgment. However, the evaluation of compounded SOFR in advance and average SOFR in advance require more judgment given the presence of certain conventions, and as such, we considered an alternative view for these rates. Specifically, those conventions include when the interest amount is not based upon current market rates (rather based on historical market rates) or if the tenor of the interest rate index and reset frequency are different.

The rationale for the conclusions reached by the ARRC subgroup is that the SOFR interest rate reset features evaluated above are in fact terms of the host contract and do not represent embedded derivatives that require further assessment of bifurcation. In other words, to define the host, consistent with current practice and FASB paragraphs ASC 815-15-25-25 and 26, we believe it is reasonable to consider among other things: (1) the substantive stated or implied terms of the hybrid instrument; (2) market conventions, both current and future expectations, including dynamic and fragmentation of the markets as products develop; (3) the underlying commercial factors that contributed to the design of the instrument; (4) whether there is an intent to provide leverage; (5) and economic equivalency. Under these principles, it may be the case that the host contract implicit in a particular product evolves over time, to the extent the above considerations also evolve.

Applying these principles to the SOFR interest rate reset features above we note:

- The ARRC has recommended the interest-rate reset features with the intention of establishing market convention;
- The purpose and intent of the SOFR interest-rate features is not to provide levered returns to investors, but a market based solution to LIBOR cessation. The *in advance* feature associated with compounded or simple average SOFR rates is designed to address circumstances in which the floating-rate payment needs to be known prior to the start of the interest accrual period, and therefore an *in arrears feature* would not be appropriate. For example, residential SOFR ARM products require use of an *in advance* feature such that lenders and servicers can provide sufficient notice of payment changes to consumers in accordance with regulations.
- Basing the interest rate features of the debt host on terms other than the contractual stated interest rate or index for the overall debt instrument, particularly when that rate or index is broadly used in the market, is not supported by ASC 815 or current practice for existing LIBOR floating-rate instruments. Further, doing so would not produce a result that is consistent with purpose and design of the instrument (e.g., substance is not that the counterparty was looking to add a complex basis swap to a plain-vanilla instrument).

We are seeking confirmation that the Office of the Chief Accountant of the SEC would not object to application of the ARRC subgroup’s view that the following SOFR interest rate reset features do not require bifurcation from the host contract and separate accounting as a derivative under ASC Topic 815, Derivatives and Hedging:

- Term SOFR rates;
- Compounded SOFR in arrears rate;
- Compounded SOFR in advance rate; and
- For ARMs, Average SOFR in advance rate that resets every 6 months and resets 45 days before the beginning of the interest period based upon the trailing 30 or 90 days SOFR average.

In the Appendix, we have attached a memorandum representing our detailed accounting analysis supporting this Proposal.

## Appendix



Embedded  
Derivative Appendix

The ARRC subgroup members appreciate the Staff's consideration of these issues and would welcome the opportunity to discuss it further. Should you have any questions or desire further clarification on any of the matters discussed in this submission, please do not hesitate to contact Jeannine Hyman at (212) 816-2114.

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