



ARRC

Summer SOFR Series

Accounting, Tax, and Regulations

Summer SOFR Series

- July 13: Libor: Entering the Endgame
- July 15: SOFR Explained
- July 22: Preparing to move from LIBOR Derivatives
- July 29: Accounting/Tax/Regulation
- August 3: Approaching the Transition
- August 7: Office Hours Live

Summer SOFR Series – Accounting/Tax/Regulation

- **Jason Granet**, Managing Director, Goldman Sachs
- **Lucy Farr**, Partner, Tax Department, Davis Polk & Wardwell LLP
- **Jeannine Hyman**, Director, Global Head of ICG and Treasury Accounting Policy, Citigroup
- **Peter Phelan**, Deputy Assistant Secretary, Capital Markets, US Treasury
- **Maria-Ines Raij**, Executive Director, Regulatory Affairs, Legal and Compliance, Morgan Stanley
- **Maureen Smith**, Director, Tax Counsel, Credit Suisse
- **Simon Winn**, COO Regulatory Strategy and Policy, BNP Paribas



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Accounting Issues

Overview of FASB Reference Rate Reform



- Response to planned phase-out of LIBOR
- Applying existing U.S. GAAP to LIBOR-based contracts would have resulted in significant accounting ramifications
- FASB had started the journey down this path with ASU Nos. 2017-12 and 2018-16 process

Policy Objectives



- Reduce cost and complexity of accounting for contract modifications and hedging relationships impacted by transition
- Designed for the relief to be scalable given the large volume of contracts expected to be modified as a result of reference rate reform
- Broadly applicable to reference rate reform (e.g. more than just LIBOR)

Optional Relief



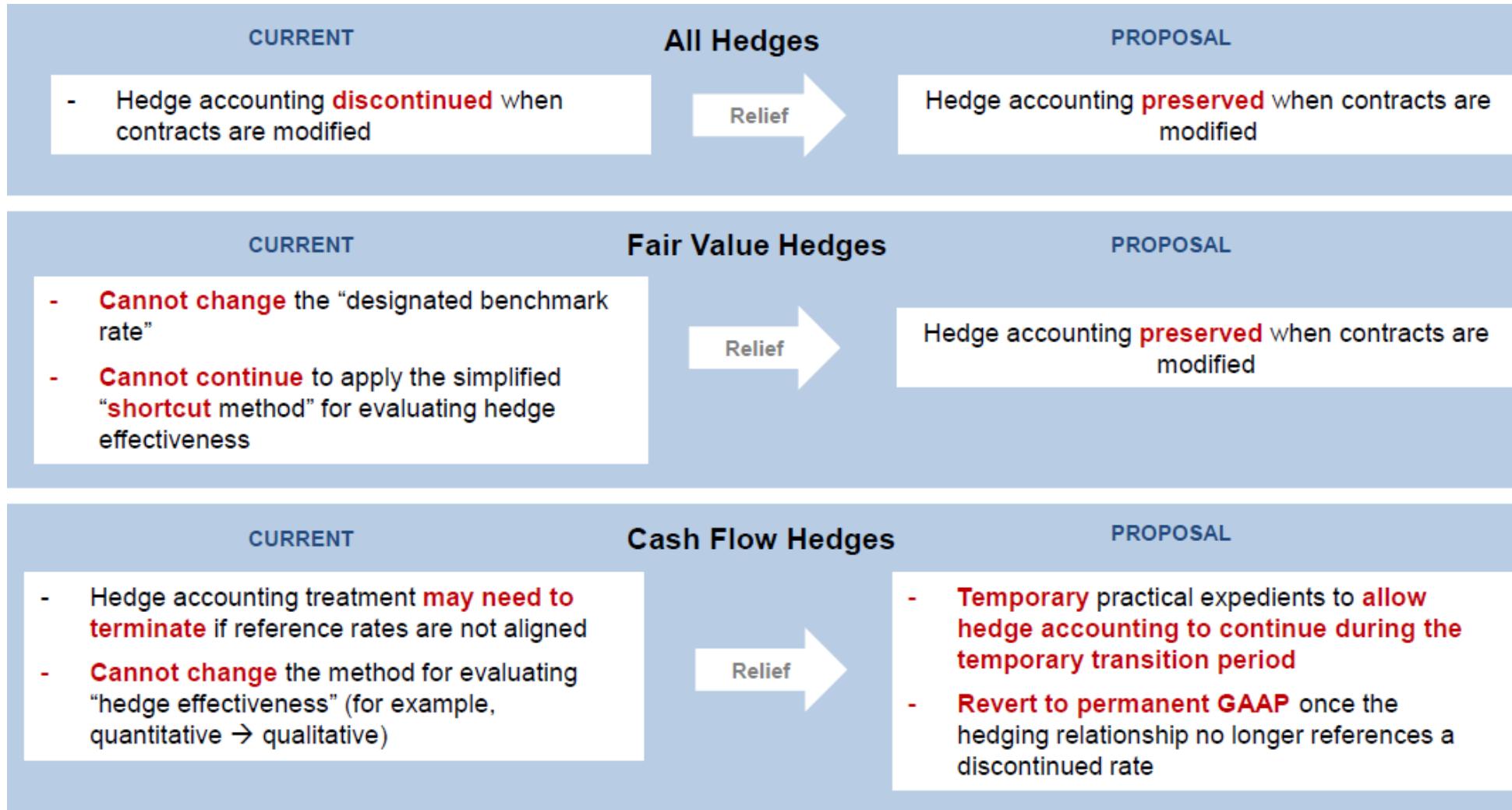
- General Principle: Contract modifications due to reference rate reform is an event that does not require contract remeasurement or reassessment
 - Exclude business decision that is separate from (or in addition to) changes in terms related to reference rate transition
- Specific modification of contracts guidance: Loans (Topic 310), Debt (Topic 470), Leases (Topics 840/842), clearly and closely test (Topic 815)
- One-time election to sell or transfer (or both) debt securities that reference a rate affected by reference rate reform and classified as HTM before January 1, 2020

Optional Relief - Hedging



- Critical terms exceptions
- Expedients for excluded components
- Specific expedients/exceptions for each of fair value and cash flow hedges

Hedge Accounting Relief



Disclosures



- Nature of and reason for electing the optional relief
- Include in interim and annual disclosure
- Additional disclosures for HTM election

Effective Date and Post-Issuance Considerations



- Generally effective from March 12, 2020 to December 31, 2022
- Specific guidance on hedging that allows for continuance through the end of the hedging relationship (narrow scope)
- Additional guidance for entities that have not adopted ASU No. 2017-12

Practical Accounting Considerations

US GAAP Accounting Relief for Contract Modifications



The FASB's relief includes examples of modifications that are presumed to be related or unrelated to the replacement of the reference rate. If a change is *related* to the replacement of the reference rate, the modification is assumed to be a continuation of the existing contract, and an entity does not have to perform additional accounting analysis.

Related Changes

- Change from one interest rate index to another
- Addition of or changes to a spread adjustment
- Change in reset period, reset date, day-count convention, business-day convention, payment dates, payment frequency, or repricing calculation
- Changes to the strike price of an existing interest rate option
- Addition of an out of the money interest rate cap or floor
- Addition of a prepayment option for which exercise is contingent upon the replacement index not being determinable
- Addition of or changes to contractual fallback terms that are consistent with fallback terms developed by a regulator or by a private-sector working group convened by a regulator (ex: ARRC, ISDA)
- Changes to terms that are necessary to comply with laws or regulations or to align with market conventions for the replacement rate

Unrelated Changes

- Change in notional or maturity date
- Change to a fixed rate
- Changes to loan structure (ex: term to revolver)
- Addition of an underlying or variable unrelated to the referenced interest rate index
- Addition of an in the money interest rate cap or floor
- Concession to a debtor experiencing financial difficulty
- Addition or removal of a prepayment or conversion option unless the exercise is contingent on the referenced index not being determinable
- Addition or removal of a feature intended to provide leverage
- Changes to counterparty except for qualifying derivative contracts
- Changes to priority or seniority of an obligation in EOD or liquidation event
- The addition or termination of a right to use one or more underlying assets in a lease contract
- Changes to renewal, termination, or purchase option provisions in a lease contract.

Other Practical Considerations



- Increasing sense of urgency around transition, and need to include business and operational stakeholders.
- Ability for a phased transition approach, and begin to test and ramp up the use of SOFR-based instruments.
- Use of HTM sale/reclassification provision.
- FASB provided both a principle and a detailed list of examples; use them in tandem to drive accounting policy conclusions.



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Tax Issues

ARRC Tax Comments – April 2019 Letter

- In April 2019, ARRC issued a comment letter seeking Treasury guidance on tax issues arising from the LIBOR (and other IBOR) transition
- Primary request: guidance that modification of (i) fallback provisions and (ii) reference rates in legacy debt, derivatives and other contracts is not a taxable event
- Potential consequences of taxable event include:
 - Gain recognition
 - Loss of grandfathering, e.g., under TEFRA bearer debt rules and FATCA
 - Potential “leg out” for hedged positions
 - Deemed reissuance of off-market derivatives – deemed loans

ARRC Tax Comments – April 2019 Letter (cont.)

- Additional guidance requests included:
 - Clarify that IBOR debt instruments are not subject to complex tax accounting rules for “contingent payment debt instruments” due to fallback contingencies
 - One-time payments in connection with contract modifications:
 - Allow parties to take reasonable position on timing and character
 - Cross-border withholding – adopt rules that would generally result in no withholding tax on cross-border payments in respect of debt and derivatives contracts

2019 Proposed Treasury Regulations Addressing IBOR Transition

- Regulations released October 8, 2019
- Regulations address most IBOR transition issues raised by ARRC
- A taxpayer generally may apply proposed rules on taxable events prior to publication of final regulations
- Clear intent to facilitate smooth market transition
 - Reflection of cooperation/coordination across private sector and government agencies

2019 Proposed Treasury Regulations Addressing IBOR Transition (cont.)

- Regulations apply broadly to debt instruments and non-debt contracts, including derivatives, stock and leases
- For legacy contract modifications, no taxable event results from:
 - Replacing a rate referencing an IBOR with a “qualified rate”
 - Adding a “qualified rate” as a fallback to the rate referencing an IBOR (or replacing an existing fallback rate with a fallback “qualified rate”)
 - Any “associated alteration” or “associated modification” accompanying the above
- Any contemporaneous modification other than changes covered by the above is tested under generally applicable law without taking into account the changes described above
- Guidance applies regardless of whether the modification occurs by amendment to existing contract or an exchange of new contract for old

2019 Proposed Treasury Regulations Addressing IBOR Transition (cont.)



- A “qualified rate” includes any of the following, provided that the rate satisfies the “fair market value requirement” and is in the same currency as the original rate
 - SOFR and a specified list of other expected replacement rates (e.g., SONIA)
 - Any rate selected by the central bank, reserve bank, monetary authority or similar institution (including any committee or working group thereof) as a replacement for an IBOR or local equivalent, or identified in IRS guidance
 - Any “qualified floating rate” as defined under Treasury Regulations
- Fair market value requirement
 - Fair market value of the instrument after the alteration or modification must be substantially equivalent to the fair market value of the instrument before the alteration or modification, after accounting for one-time payments
 - Safe harbors for (i) rates based on certain historic averages and (ii) arm’s length negotiations

2019 Proposed Treasury Regulations Addressing IBOR Transition (cont.)



- An “associated alteration or modification” may be a technical, administrative, or operational alteration or modification that is (i) associated with the alteration or modification by which a qualified rate replaces, or is included as a fallback to, the IBOR-referencing rate; and (ii) reasonably necessary to adopt or to implement that replacement or inclusion
 - E.g., change to the definition of interest period
- Additional guidance includes:
 - No contingent payment debt treatment as a result of fallback provisions
 - Modification does not result in loss of hedging transaction or integrated transaction status
 - Source and character of one-time payments same as payment on underlying transaction that is altered or modified
 - Preamble clarifies no loss of grandfathering for modified contracts eligible for relief under the regulations

Open Issues -- ISDA Protocol

- In December 2019, ARRC requested interim guidance that adherence to the anticipated ISDA Protocol and comparable bilateral modifications will not trigger a taxable event
 - Primary concern is FMV requirement because of lack of clarity that safe harbors apply, although request is for broad guidance
 - Historic average of rates safe harbor requires testing on the modification date, while ISDA Definitions will compute spread adjustment on trigger date
 - Arm's length negotiations safe harbor may not apply because Protocol does not generally involve negotiations
 - “Comparable” amendments could include amendments to non-ISDA contracts (including hedged positions), fallbacks with pre-cessation triggers, changes reflecting administrative or scope issues

Open Issues—Final Regulations

- In its March 2020 letter, ARRC raised the following primary recommendations for the final regulations:
 - *Taxable events*
 - Create a “fast track” rule that would clarify no taxable event for parties including standard fallback provisions in legacy contracts (i.e., ISDA, ARRC and substantially similar provisions)
 - Eliminate FMV requirement for contract modifications between unrelated parties generally and between related parties unless “other contemporaneous modifications” are made
 - Add new safe harbor for FMV requirement where changes conform with those permitted in FASB reference rate relief

Open Issues—Final Regulations (cont.)

- Primary recommendations (cont.):
 - *One-time payments*: Reiteration of requests for rules permitting parties to take reasonable position on timing and character and eliminating potential withholding tax on cross-border payments
 - *Hedging*: Request for additional flexibility in applying tax hedging rules



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Regulatory Issues

The ARRC Regulatory WG

- **The group's objective is to identify potential regulatory hurdles that could hinder the transition away from USD LIBOR.** The group then highlights these issues to regulatory agencies and self-regulatory organizations in order to help facilitate the uptake of SOFR and help minimize potential disruptions in the event that USD LIBOR is no longer usable.
- **Scope includes market and prudential regulations**
- **Broad representation.** WG members represent dealers, regional banks, asset managers, trade associations including corporate trade associations, GSE's, insurance companies and various government agencies.

Key Principles

- **Existing IBOR transactions can continue under a voluntary transition to the new RFR without requiring a renegotiation of other, unrelated terms or newly triggering swap regulatory requirements.**
- **Flexibility for different transition mechanisms.** There is not one size fits all in transitioning existing transactions and conversion models which are made for the purposes of effectuating the transition from LIBOR to the new RFRs will also vary.

Banking Regulators Swap Relief

- In October 2019, the Federal Reserve Board, the OCC, and the FDIC proposed rules that would exclude legacy swaps amended as part of IBOR transitions from their swap margin requirements.
- In June 2020, the U.S. banking regulators adopted amendments to their margin and capital rules, which include relief for legacy transactions that is broadly similar to the relief provided by the CFTC.
- Additional relief in the rules for DCO discounting changes.

CFTC Relief Granted*

Topic	Relief
Uncleared swap margin (relief also provided by prudential regulators)	✓
Mandatory clearing and end-user clearing exception	✓
Mandatory SEF execution	✓
Swap dealer de minimis threshold	✓
Business conduct requirements	✓
Confirmation requirements	✓
Swap trading relationship documentation	✓
Portfolio reconciliation	✓
Eligible contract participant requirement for natural persons	✓
Reporting	Under Discussion with CFTC

- * In December, 2019 the CFTC issued Letters Nos. 19-28, 19-27, and 19-26, providing various no-action relief. The CFTC generally provided relief that preserves the current treatment of a swap (including for margin purposes) as long as an amendment to the swap was affected solely to achieve the purposes of the transition. All relief subject to conditions and some relief limited in scope. In July 2020 the ARRC further submitted a request requesting some modifications to this relief. These requests are summarized in an issues list submitted along with the letter.
- In June 2020 the ARRC filed a letter requesting no-action relief providing that the exchange of voluntary compensation for a swaption, or the amendment of a swaption's terms to reflect an agreement regarding the discount rate that will be used by a derivatives clearing organization ("DCO") in advance of the DCO's discounting changes would be treated as a "Qualifying Amendment" under DSIO's existing IBOR relief letter (19-26)

Capital and Liquidity Regulations

- ARRC memorandum is in process, discussing the capital and liquidity considerations related to the transition and recommendations to avoid potential unintended and temporary effects of the transition on regulatory capital and liquidity requirements that may inadvertently discourage a timely transition related to:
 - **Model-Related Considerations**
 - **Recalibration-Related Considerations**
 - **Amendment-Related Considerations**
 - **Other Effects**
- BCBS published, June 05, a Q&A addressing application of certain international capital and liquidity standards in light of the transitions in many of its member jurisdictions from IBORs to RFRs

SEC Regulations in Scope

A number of issues are also under discussion with the SEC

Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act) and the SEC's regulations

- Security-Based Swap Dealer Registration Counting
- Eligible Contract Participant Status
- Trade Acknowledgment and Verification
- Trading Relationship Documentation
- Portfolio Reconciliation Requirements
- Margin Requirements for Un-cleared Security-Based Swap
- Business Conduct Requirements
- Security-Based Swap Records
- Security-Based Swap Reporting
- Beneficial Ownership Reporting