INVESTMENT COMPANY INSTITUTE

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March 16, 2020

FASB Adopts Relief for LIBOR Transition

[32287]

March 16, 2020 TO: ICI Members SUBJECTS: Fund Accounting & Financial Reporting RE: FASB Adopts Relief for LIBOR Transition

The Financial Accounting Standards Board recently adopted an Accounting Standards Update that provides temporary optional relief intended to ease the transition from LIBOR to alternative reference rates.[1] The ASU permits an entity to not apply certain modification accounting requirements in GAAP to contracts affected by the transition from LIBOR to alternative reference rates. For contracts in scope, the entity may present and account for the modified contract as a continuation of the existing contract. The relief is effective immediately and applies to contract modifications through December 31, 2022.

Background

LIBOR is used as a reference rate in in a broad range of financial instruments, including loans and debt securities, but banks that report information used to set the rate will no longer be required to do so after 2021. Regulators have undertaken reference rate reform initiatives to identify alternative reference rates that are more observable, or transaction based. The transition to alternative reference rates will require contracts to be modified. For accounting purposes, such contract modifications are required to be evaluated to determine whether the modification results in the establishment of a new contract or the continuation of the existing contract. For an investment company, a modification that results in the establishment of a new contract may cause termination of the existing contract or security and result in realized gain/loss and portfolio turnover.

The application of existing accounting standards on modifications may be costly and burdensome due to significant volumes of contracts that reference LIBOR and compressed time frames. The temporary optional relief is intended to ease the potential burden in accounting for or recognizing the effects of reference rate reform on financial reporting.

Temporary Optional Relief

Modified contracts that meet the following criteria are eligible for relief from the modification accounting requirements in GAAP:

- The modifications change, or have the potential to change, the amount or timing of contractual cash flows; and
- All the modifications relate to the replacement of LIBOR or a reference rate that is expected to be discontinued.

The relief does not apply if a contract modification is made to a term that changes, or has the potential to change, the amount or timing of contractual cash flows and is unrelated to the replacement of a reference rate. That is, the relief does not apply if contract modifications are made contemporaneously to terms that are unrelated to the replacement of a reference rate.

The ASU includes examples of changes to contractual terms that are related to the replacement of the reference rate. For example, changes to a spread adjustment, changes to the reset period, reset dates, day count conventions, payment dates, payment frequency, and repricing calculations (*e.g.*, a change from a forward-looking term rate to an overnight rate or a compounded overnight rate in arrears) would all be considered related to the replacement of the reference rate.

Changes to terms that are the result of new business decisions separate from the transition for reference rate reform are not considered related and do not qualify for the temporary optional relief. Such changes include, for example, changes to the notional amount, changes to the maturity date, changes from a referenced interest rate to a stated fixed rate, a concession granted to a debtor experiencing financial difficulty, or changes to the priority or seniority of an obligation in the event of a default or a liquidation event.

The addition of contractual fallback terms, or the amendment of existing fallback terms, to be consistent with fallback terms developed by a regulator or by a private-sector working group convened by a regulator (*e.g.*, the ARRC or ISDA) is presumed to be related to reference rate reform.

For contracts in scope, the ASU generally would allow an entity to account for and present the modified contract as a continuation of the existing contract, rather than derecognition of a contract and initial recognition of a new contract. Under the ASU if an entity elects to apply the optional relief, it would need to do so for all contract modifications in scope that otherwise would be accounted for in accordance with the same Topic or Subtopic in the accounting standards codification.

The ASU provides temporary option relief for hedge accounting relationships and held to maturity debt securities, which generally do not apply to investment companies.

Disclosure

An entity relying on the temporary optional relief must disclose the nature of and reasons for electing to apply the relief. Such disclosure should be provided in each interim and annual financial statement period in the fiscal year of application.

The FASB considered requiring additional disclosures including: i) management's approach and its progress on addressing an entity's exposure to anticipated discontinued reference rates, ii) the percentage or dollar amount of financial instruments that contain contract provisions that adequately contemplate discontinuance of the reference rate, and iii) the percentage or dollar amount of financial instruments that do not contemplate discontinuance and would require additional negotiation. Consistent with comments submitted by ICI,[2] the FASB decided not to require these additional disclosures.

Effective Date and Sunset

Entities may apply the ASU as of the beginning of the interim period that incudes March 12, 2020 or any date thereafter. The temporary optional relief does not apply contract modifications made after December 31, 2022.

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endnotes

[1] ASU No. 2020-04, Reference Rate Reform (Topic 848), *Facilitation of the Effects of Reference Rate Reform on Financial Reporting* (March 12, 2020) *available at* https://fasb.org/jsp/FASB/Page/SectionPage&cid=1176156316498

[2] *See* ICI Memorandum No. 32001 (October 9, 2019).
