November 27, 2019

Governmental Accounting Standards Board  
Director of Research and Technical Activities, Project No. 26-8  
director@gasb.org

Dear Sir / Madam –

Mohanty Gargiulo LLC (“MG LLC”) is a leading municipal advisory firm specializing in derivatives and capital markets advisory. We service a large array of municipal entities, including some of the largest municipal issuers with large and diverse derivatives portfolios. As part of our services, we assist our clients in the evaluation of hedge effectiveness, as well as with issues related to accounting treatment for derivative transactions including new transactions, terminations, and amendments. MG LLC does not provide accounting advice but instead works with our clients’ finance and accounting departments, as well as our clients’ auditors, to clarify accounting treatments and implications.

We appreciate The Governmental Accounting Standards Board (“GASB” or “The Board”)’s efforts to address issues related to the expected replacement of the London Interbank Offered Rate (LIBOR) and the opportunity to comment on the Exposure Draft published on September 16, 2019.

Our comment letter addresses certain items in the Exposure Draft, and points to certain additional clarifications, that we believe would be beneficial to municipal issuers.

1. Exposure Draft on Replacement of Interbank Offered Rates

   Exception to Termination of Hedge Accounting

   • Under Exception to Termination of Hedge Accounting, Paragraph 4, The Board is limiting the changes in hedging derivative instruments to the amendment and replacement of the reference rate, including adjustment via a spread or coefficient which would effectively equate the replacement rate with the original rate. The Board should consider clarifying that such amendments may also be executed through equivalent adjustments of the fixed rate of the swap. For example, converting a percent of LIBOR-based swap to a SIFMA-based swap would most often involve an increase in the fixed rate. While it is possible to adjust the SIFMA floating leg to SIFMA minus a spread and keep the fixed rate the same, it is more common in such restructurings to increase the fixed rate on the swap (economically, this arrives at the same result). Similarly, a transition from LIBOR to SOFR would likely result in a spread added to the floating-rate leg, which is effectively a decrease in the fixed rate.

   • Related to this paragraph, it would be helpful if The Board clarifies the concept of equating the replacement rate and the original rate. Would that mean that the present value of the original floating leg should be equal to the present value of the new floating leg (i.e., an at-market conversion) or can it be based on an adjustment taking into account historic data between the two rates (even if as a result, the present value of the legs are not equal and other adjustments to the swap may be needed)? Our interpretation is the former; however, depending on whether the swap restructurings is done prior to the LIBOR discontinuation, or at the time of
LIBOR discontinuation based on an adopted ISDA protocol, the adjustment methods can be different. In addition, there is not yet enough clarity as to whether there would be no change in the MTM upon the transition.

- We believe that The Board should reconsider allowing for broader restructurings that would allow a one-time change to the swap’s notional, maturity, and fixed rate, rather than only a change in the floating-rate index and terms related to resets and payment conventions. As issuers are compelled to restructure LIBOR swaps into swaps based on other rates, such as SIFMA or SOFR, they would be looking to ensure that the restructured derivative will continue to provide an effective hedging relationship and, when possible, to avoid increases in the overall swap rate due to the change in index (please see the examples below), as such increase may also have a negative impact for budgeting, coverage ratios, etc. The Board can consider allowing such broad one-time restructurings over a limited time-window – for example, from 2020 to 2022 – so it can preserve the underlying principles of the Standard after the transition period has passed.

  - Swap conversions to SIFMA illustrate the above point. We expect that many issuers would prefer replacement based on SIFMA due to lack of familiarity with the SOFR index, as well as lack of enough history to assess the basis risk between the SOFR index and variable-rate debt based on SIFMA. This is especially true for proactive conversions prior to LIBOR’s discontinuation and replacement, given that the SOFR swap market is not yet well-developed. As discussed in the first bullet above, conversions to SIFMA, in most cases, result in a higher fixed rate on the swap. Market conditions may allow issuers to avoid an increase in the swap’s fixed rate by adding additional notional or extending the maturity of the swap upon a conversion to SIFMA. For example, issuers may be able to lower the fixed rate on the restructured swap by extending the maturity of the swap (i.e. achieving a lower, blended rate by adding additional swap flows at current market rates) or increasing the notional of the swap (achieving a lower rate by adding additional notional at current lower market rates). While we recognize that these restructurings involve effectively establishing additional hedging relationships, allowing for such restructurings would allow issuers to seamlessly transition to SIFMA-based swaps. It would be a reasonable requirement that the issuer is able to identify the hedgeable items for the notional added, i.e. in order to restructure via an increase in notional, there should be underlying debt that is being hedged.

  - Another example as to why such flexibility may be needed is upon transition from a percent of LIBOR swap to SOFR when hedging SIFMA-based tax-exempt bonds. When entering into a percent of LIBOR swap, issuers assess how effective the percent of the floating LIBOR index would be as a cash flow hedge for the variable flows of the bonds. For example, an issuer may have a 67% of 1-Month LIBOR swap as a cash flow hedge for variable-rate demand bonds. In the current market environment, this could be restructured to approximately 71% of SOFR which effectively equates the present value of the two floating legs and keeps the fixed rate unchanged. However, the issuer may determine, based on historic analysis, that 71% of SOFR is not expected to be an effective cash flow hedge and decide to change the percent of SOFR to a higher percent (which would also increase the fixed rate) or vice versa. Under that scenario, the swap is modified not with the goal to equate the replacement rate with that of the original rate,
but with the goal to maintain cash flow hedge effectiveness given the relationship of the new rate to that of the hedgeable item.

- The Board should also consider that certain instruments that contain LIBOR-based options may require restructurings beyond just a change in the reference rate and parameters related to reset and payment frequencies, as listed in Paragraph 5. It is possible that a conversion of a callable LIBOR swap may involve adjustments to the fixed rate and/or a possible exchange of payments. We would note that since 2008, cancelable/callable swaps have become more common as issuers look to preserve flexibility and reduce mark-to-market exposure, and currently there is still a lack of clarity as to modifications related to the LIBOR replacement.

Appropriate Benchmark Interest Rates

- The Board has stated that LIBOR will not be considered an appropriate benchmark rate for reporting periods after December 15, 2020. While the current expectation is that LIBOR may not be published past 2021, there is a possibility of delays in the transition, as well as the existence of legacy contracts (both bonds and derivatives) for some time. Given this, The Board may want to leave some room for flexibility and only remove LIBOR as a benchmark if there is an adverse announcement regarding its viability as a benchmark by a regulator.

2. Other Guidance - Investment Derivatives

- Dislocations in short-term rates have caused a number of hedging derivatives to fail hedge effectiveness tests and be classified as investment derivatives. These transactions are still compliant with the issuer’s policies as they serve the economic purpose of fixing a portion of the floating-rate debt; however, for accounting purposes they are classified as investment derivative instruments. While changes in the fair value/mark-to-market of these derivatives are already reported on issuers’ flow of resources statements, it would be helpful to address the potential transition and clarify whether an amendment to the terms related to a transition from LIBOR could be treated as a non-event in the sense that the contract continues, rather than a termination of the old contract and the establishment of a new, off-market contract.

As the market transition progresses, we believe that many municipal issuers would be looking for proactive solutions and assessing implications related to LIBOR’s discontinuation. This would necessitate timely guidance on issues related to accounting treatment. In addition, given the uncertainties around the transition’s mechanics and the development of a derivatives market and SOFR term rates, we believe that a broader-based approach to the restructurings over a limited timeframe would avoid unintended consequences and provide maximum flexibility to municipal entities.

We appreciate the opportunity to provide comments to The Board and are available for further discussions that can help ensure a minimally disruptive transition for our clients and public finance entities.

Sincerely,

Zoya Gargiulo  Andrew Rothbaum
Managing Director  Director