

**Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A**

Issue: Reference Rate Reform**Check (applicable entity):**

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue:

The Financial Accounting Standards Board (FASB) issued ASU 2020-04 *Reference Rate Reform (Topic 848) Facilitation of the Effects of Reference Rate Reform on Financial Reporting* as a method to ensure that the financial reporting results would continue to reflect the intended continuation of contracts and hedging relationships during the period of the market-wide transition to alternative reference rates – thus, generally not requiring remeasurement or dedesignation if certain criteria are met.

Reference rate reform typically refers to the transition away from referencing the London Interbank Offered Rate (LIBOR), and other interbank offered rates (IBORs), and moving toward alternative reference rates that are more observable or transaction based. In July 2017, the governing body responsible for regulating LIBOR announced it would no longer require banks to continue rate submissions after 2021 – thus, likely sunsetting both the use and publication of LIBOR. An important item to note is that while LIBOR is the primary interbank offering rate, other similar rates are potentially affected by reference rate reform. For simplicity, LIBOR will be the sole IBOR referenced throughout this agenda item.

With a significant number of financial contracts referencing LIBOR, its discontinuance will require organizations to reevaluate and modify any contract which does not contain a substitute reference rate. A large volume of contracts and other arrangements, such as debt agreements, lease agreements, and derivative instruments, will likely need to be modified to replace all references of interbank offering rates that are expected to be discontinued. While operational, logistical, and legal challenges exist due to the sheer volume of contracts that will require modification, accounting challenges were presented as contract modifications typically require an evaluation to determine whether the modifications result in the establishment of a new contract or the continuation of an existing contract. As is often the case, **a change to the critical terms (including reference rate modifications) typically requires remeasurement of the contract, or in the case of a hedging relationship, a dedesignation of the transaction.**

The overall guidance in ASU 2020-04 is that a qualifying modification (as a result of reference rate reform) should not be considered an event that requires contract remeasurement at the modification date or reassessment of a previous accounting determination. FASB concluded that as reference rate changes are a market-wide initiative, one that is required primarily due to the discontinuance of LIBOR, it is outside the control of an entity and is the sole reason compelling an entity to make modifications to contracts or hedging strategies. As such, FASB determined that the traditional financial reporting requirements of discontinuing such contracts and treating the modified contract as an entirely new contract or hedging relationship would 1) not provide decision-useful information to financial statement users and 2) require a reporting entity to incur significant costs in the financial statement preparation and potentially reflect an adverse financial statement impact, one of which may not accurately reflect the intent or economics of a modification to a contract or hedging transaction.

Stakeholders indicated that due to the significant volume of affected contracts and other arrangements, together with a compressed time frame for making contract modifications, the application of existing accounting standards on assessing modifications versus extinguishments could be costly and burdensome and financial reporting results should reflect the intended continuation and true economics of such arrangements. It is important to note this as **the**

optional, expedient and exceptions guidance provided by the amendments in ASU 2020-04 are applicable for all entities, however, are only effective as of March 12, 2020 through December 31, 2022.

Finally, while numerous alternative reference rates are available, the Federal Reserve has identified the Secured Overnight Financing Rate (SOFR) as its preferred alternative to LIBOR. SOFR is calculated using actual transactions and is considered a broad measure of the cost of borrowing cash overnight, fully collateralized by risk-free treasury securities. LIBOR, on the other hand, is set by a panel of banks submitting estimates of what they think their borrowing costs are and represents a benchmark rate that leading global banks charge each other for short-term loans, thus incorporating a degree of credit risk into the reference rate. Unlike SOFR, LIBOR is determined by the equilibrium between supply and demand in the funds market.

General Principles:

For contract modifications, hedging relationships, and other transactions affected by reference rate reform, the amendments provide temporary guidance that achieves the following:

1. Simplifies accounting analyses under current GAAP for contract modifications.
2. Allows hedging relationships to continue without dedesignation upon a change in certain critical terms.
3. Allows a change in the designated benchmark interest rate to a different eligible benchmark interest rate in a fair value hedging relationship.
4. Suspends the assessment of certain qualifying conditions for fair value hedging relationships for which the shortcut method for assuming perfect hedge effectiveness is applied.
5. Simplifies or temporarily suspends the assessment of hedge effectiveness for cash flow hedging relationships.

The overall scope is that for the modification of a contract (hedging or other) to be eligible for the accounting exceptions provided in ASU 2020-04, the contract must reference LIBOR, or a reference rate that is expected to be discontinued as a result of reference rate reform.

In relation to hedge accounting, without this accounting exception, a change in a contract's reference rate could disallow the application of certain hedge accounting guidance, and certain hedging relationships may not qualify as highly effective during the period of the market-wide transition to a replacement rate. The inability to apply hedge accounting solely because of reference rate reform would result in financial reporting outcomes that do not reflect entities' intended hedging strategies when those strategies continue to operate as effective hedges. ASU 2020-04 provides optional expedients that enable reporting entities to continue to apply hedge accounting for hedging relationships in which the critical terms change, but due to reference rate reform may no longer indicate the hedge is effective. The relief is temporary and cannot be applied to contract modifications that occur after December 31, 2022, or hedging relationships initiated or evaluated after that date. This is because the amendments in ASU 2020-04 are intended to provide relief related to the accounting requirements in GAAP due to the effects of the market-wide transition away from IBORs, the relief provided by the amendments is temporary in its application in alignment with the expected market transition period.

Contract Modifications:

First, the scope of ASU 2020-04 is intended to distinguish contract modifications that occur solely because of reference rate reform from other contract modifications that occur in the ordinary course of business, or for reasons unrelated to reference rate reform. Again, the scope of contract modifications that are eligible for the optional expedience (and not required to be remeasured) shall only include changes that are being made to the terms that include the direct replacement of a reference rate or the potential to replace a reference rate from one variable rate to another variable rate. Other contemporaneously modified terms must also be related to the replacement of a reference rate because of reference rate reform. Solely modifying a term or a reference rate not affected by reference rate reform does not qualify for the expedience or the accounting exceptions provided in this update.

For qualifying contract modifications, the guidance generally allows a reporting entity to account for and report such modifications as an event that does not require the contract termination and remeasurement – **thus the modifications are to be reported as a continuation of the existing contract**. For the purpose of the amendments in ASU 2020-04, the terms that are permitted to be modified could be those in which affect or have the potential to affect the amount or timing of future cash flows or may include modifications of terms such as fallback provisions in a contract that are triggered upon a contingent event (such as the discontinuance of a reference rate). However, accounting for these changes as a continuation of the existing contract is only allowed if the modifications were required as a result of reference rate reform. Finally, minor contemporaneous changes to terms that do not affect or have the potential to affect the amount or timing of future cash flows are also permitted by ASU 2020-04.

For Receivable or Debt Contracts – A reporting entity shall account for the qualified contract modifications as a minor change, resulting in the modification being **accounted for prospectively** as a continuation of the existing contract, while using the new reference rate/terms in the agreement.

For Leases – A reporting entity shall not reassess the lease classification, remeasure lease payments, or make other assessment, but rather the lease is **accounted for prospectively** as a continuation of the existing contract.

Overall Hedge Accounting:

The amendments in ASU 2020-04 provide several exceptions and optional expedients for applying hedge accounting guidance. If certain criteria are met, for hedging relationships, the guidance in ASU 2020-04 allows an entity to change the reference rate and certain other critical terms related to reference rate reform without having to dedesignate the relationship and hedging transaction.

Summarized below are the four primary considerations for hedge accounting. Note, the exceptions noted below only relate to critical term changes as a result of reference rate reform. Thus, a contemporaneous change in other terms, not as a result of reference rate reform, does not qualify for the exception and optional expedient guidance herein.

1. For any hedging relationship, upon a change to the critical terms of the hedging relationship, allow a reporting entity to continue hedge accounting rather than dedesignate the hedging relationship.
2. For any hedging relationship, upon a change to the terms of the designated hedging instrument, allow an entity to change its systematic and rational method used to recognize the excluded component into earnings and adjust the fair value of the excluded component through earnings.
3. For fair value hedges, allow a reporting entity to change the designated hedged benchmark interest rate and continue fair value hedge accounting.
4. For cash flow hedges, adjust the guidance for assessment of hedge effectiveness to allow an entity to continue to apply cash flow hedge accounting.

The temporary guidance in ASU 2020-04 only applies to eligible hedging relationships that currently exist or are entered into prior to December 31, 2022.

Fair Value Hedges

For fair value hedges, in which the designated benchmark interest rate is LIBOR, a reporting entity may change the hedged risk to another permitted benchmark interest rate without dedesignating the relationship, as long as the hedge is expected to remain highly effective in offsetting changes in fair value attributed to the revised hedged risk. The amendments in ASU 2020-04 require that an entity recognize in current earnings any change in fair value attributable to a change in an eligible benchmark interest rate.

Current GAAP allows an entity to apply the shortcut method for assessing hedge effectiveness of fair value hedges if certain conditions are met. For fair value hedges applying the shortcut method, the amendments in ASU 2020-04 provide an optional expedient to allow an entity to continue to use the shortcut method if the reference rate in the

hedging instrument is replaced by another eligible benchmark interest rate. For an entity that qualifies for and elects to use the optional expedient, the entity would continue to use the shortcut method and recognize the changes in fair value of the hedging instrument as a fair value hedge basis adjustment of the hedged asset or hedged liability.

Cash Flow Hedges

For a cash flow hedge to qualify for hedge accounting, an entity must assert that the hedged forecasted transaction is probable of occurring. A change in the probability of the forecasted transaction may require that an entity discontinue hedge accounting and may affect the timing of recognizing in current earnings amounts previously deferred in accumulated other comprehensive income.

The amendments in ASU 2020-04 clarify that if the designated hedged risk in a hedged forecasted transaction references LIBOR or another rate that is expected to be discontinued because of reference rate reform, an entity may assert that the hedged forecasted transaction remains probable of occurring if the reference rate is replaced with another rate. However, the amendments require that an entity assess whether the underlying hedged forecasted transaction remains probable of occurring. A change to the designated hedged interest rate risk does not require a dedesignation of a cash flow hedge of a forecasted transaction if the hedge is remains highly effective – that is if the entity can assert that the underlying cash flows remain probable, regardless of how the hedged risk and hedged forecasted transaction are documented.

Additionally, there may be periods of time during the transition to replacement rates in which a cash flow hedge would not be considered highly effective because of the basis differences between the reference rates in the hedging instrument and the reference rates in the hedged forecasted transaction. In these cases, if a hedging relationship qualifies for cash flow hedge accounting, all changes in the fair value of the derivative designated as the hedging instrument shall be deferred into accumulated other comprehensive income and recognized in earnings when the hedged forecasted transaction affects earnings. Despite the potential of a hedge not being considered highly effective (solely as a result of reference rate reform), the ASU designates that the reporting entity shall not discontinue hedge accounting and dedesignate the hedging transaction. Again, the temporary relief provided cannot be applied to contract modifications after December 31, 2022, or with hedging relationships entered into or evaluated after that date.

NAIC Staff Final Hedge Comments:

For GAAP purposes, if an entity has not adopted the amendments in *ASU 2017-12, Derivatives and Hedging*, it is precluded from being able to utilize certain expedients for hedge accounting. Only the hedge documentation requirements were adopted for statutory accounting purposes, while the remainder of the items are still outstanding. **For statutory accounting, NAIC staff support allowing all available expedient methods permitted if an entity has elected ASU 2017-12 for GAAP purposes.**

Other Items:

ASU 2020-04 also allows an entity to make a one-time election to sell, transfer, or both sell and transfer debt securities classified as held-to-maturity that reference a rate affected by reference rate reform and that are classified as held to maturity before January 1, 2020.

Note that, debt classification such as held-to-maturity, available-for-sale, or trading are not concepts employed by statutory accounting and thus are not applicable.

Existing Authoritative Literature:

ASU 2020-04 has affects related to several different Statements of Statutory Accounting Principles, each will be individually addressed.

SSAP No. 15—Debt and Holding Company Obligations

NAIC Staff comment – Debt and service agreement modifications as a result of reference rate reform should not rise to the level requiring a reversal and rebooking of the liability. SSAP No. 15, states such liabilities should only be derecognized if extinguished. A reference rate modification should not be interpreted as necessarily requiring re-recognition. Nonetheless, for clarity and consistency with ASU 2020-04, NAIC staff recommend the Working Group adopt this temporary guidance as appropriate for SSAP No. 15.

11. A reporting entity shall derecognize a liability if, and only if, it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- a. The reporting entity pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods or services, or reacquisition by the debtor of its outstanding debt securities; or
- b. The reporting entity is legally released from being the primary obligor under the liability, either judicially or by the creditor.

15. Modifications to or exchanges of line-of-credit or revolving-debt arrangements, including the accounting for unamortized costs at the time of the change, fees paid to or received from the creditor and third-party costs incurred shall be expensed when incurred.

SSAP No. 22R—Leases

NAIC Staff comment – lease modifications, solely caused by reference rate reform and ones eligible for optional expedience (modifications only being made to the terms that include the direct replacement of a reference rate or the potential to replace a reference rate from one variable rate to another variable rate) likely do not rise to the level of a modification requiring recognition as a new lease under statutory accounting. SSAP No. 22R, paragraph 17 states only modifications in which grant the lessee additional rights shall be accounted for as a new lease. These changes are outside the scope allowed for optional expedience in ASU 2020-04. Nonetheless, for clarity and consistency with ASU 2020-04, NAIC staff recommend the Working Group adopt this temporary guidance as appropriate for SSAP No. 22R.

Modification

17. An entity shall account for a modification to a contract as a separate contract (that is, separate from the original contract) when both of the following conditions are present:

- a. The modification grants the lessee an additional right of use not included in the original lease (for example, the right to use an additional asset).
- b. The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

18. An entity shall account for initial direct costs, lease incentives and any other payments made to or by the entity in connection with a modification to a lease in the same manner as those items would be accounted for in connection with a new lease.

Accounting and Reporting by Lessees

19. All leases shall be considered operating leases, which means that rental expense is recognized over the lease term, without recognition of a right-to-use asset or lease liability. Rent on operating leases, reflecting all lease considerations in paragraph 20, shall be charged to expense on a straight-line basis over the lease term. Statutory accounting rejects the recognition of a right-to-use lease asset and the associated lease liabilities.

20. The consideration in the contract for a lessee includes all of the following payments that will be made during the lease term:

- a. Any fixed payments (for example, monthly service charges) or in substance fixed payments, less any incentives paid or payable to the lessee.
- b. Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the commencement date.

SSAP No. 86—Derivatives

NAIC Staff comment – The modifications in ASU 2020-04 most primarily address hedge accounting and the allowance for a reporting entity to change the reference rate and other critical terms related to reference rate reform without having it dedesignate the hedging relationship. While alternative benchmark interest rates were previously addressed in agenda item 2018-46 – Benchmark Interest Rate, the accounting for hedged transactions is noted below, with applicable areas bolded for emphasis.

Relevant/Applicable of Overview of existing SAP Accounting – SSAP No. 86

12. “Benchmark Interest Rate” is 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. In the United States, the interest rates on direct Treasury obligations of the U.S. government, the London Interbank Offered Rate (LIBOR) swap rate, the Fed Funds Effective Rate Overnight Index Swap Rate, the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate, and the Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate are considered to be benchmark interest rates.

Derivatives Used in Hedging Transactions

20. Derivative instruments used in hedging transactions that meet the **criteria of a highly effective hedge shall be considered an effective hedge and are permitted to be valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting)**. For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. **If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost.** Derivative instruments used in hedging transactions that do not meet or no longer meet the criteria of an effective hedge, or that meet the required criteria but the entity has chosen not to apply hedge accounting, shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

21. Entities shall not bifurcate the effectiveness of derivatives. A derivative instrument is either classified as an effective hedge or an ineffective hedge. Entities must account for the derivative using fair value accounting if it is deemed to be ineffective or becomes ineffective. Entities may redesignate a derivative in a hedging relationship even though the derivative was used in a previous hedging relationship that proved to be ineffective. **A change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a termination of the derivative instrument.** An entity shall prospectively discontinue hedge accounting for an existing hedge if any one of the following occurs:

- a. Any criterion in paragraphs 24-36 is no longer met;
- b. The derivative expires or is sold, terminated, or exercised (the effect is recorded as realized gains or losses or, for effective hedges of firm commitments or forecasted transactions, in a manner that is consistent with the hedged transaction – see paragraph 22);

- c. The entity removes the designation of the hedge; or
- d. The derivative is deemed to be impaired in accordance with paragraph 17. A permanent decline in a counterparty's credit quality/rating is one example of impairment required by paragraph 17, for derivatives used in hedging transactions.

22. For those derivatives which qualify for hedge accounting, the change in the carrying value or cash flow of the derivative shall be recorded consistently with how the changes in the carrying value or cash flow of the hedged asset, liability, firm commitment or forecasted transaction are recorded. **Upon termination of a derivative that qualified for hedge accounting, the gain or loss shall adjust the basis of the hedged item and be recognized in income in a manner that is consistent with the hedged item (alternatively, if the item being hedged is subject to IMR, the gain or loss on the hedging derivative may be realized and shall be subject to IMR upon termination.)** Entities who choose the alternative method shall apply it consistently thereafter.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Agenda item 2018-46 – Benchmark Interest Rate, incorporated revisions to SSAP No. 86, adding the Securities Industry and Financial Markets (SIFMA) Municipal Swap Rate and the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as acceptable benchmark interest rates for hedge accounting. Prior to this change, only LIBOR and the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate) were considered acceptable benchmark interest rates.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:
N/A

Convergence with International Financial Reporting Standards (IFRS): IFRS has taken a similar approach when considering Reference Rate Reform's impact on IFRS 9 (Financial Instruments), IAS 39 (Recognition and Measurement), and IFRS 7 (Financial Instruments – Disclosures).

Staff Recommendation: Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose temporary (optional) expedient and exception interpretative guidance, with a sunset date of December 31, 2022. These optional expedients would allow entities (under certain circumstances) to avoid having to remeasure contracts or reassess a previous accounting determination for hedged items. With this guidance, reporting entities would be allowed to make specific contract modifications and account for them on a prospective basis. Further, entities would be allowed to continue applying hedge accounting for hedging relationships affected by reference rate reform. Note: NAIC staff support adoption of this ASU, with the only modification related to the option to sell debt currently classified held-to-maturity. This concept is not employed by statutory accounting and thus is not applicable.

The proposed extension temporarily overrides guidance in SSAP No. 15, SSAP No. 22R and SSAP No. 86 for affected policies, therefore the policy statement in Appendix F requires 2/3rd (two-thirds) of the Working Group members to be present and voting and a supermajority of the Working Group members present to vote in support of the interpretation before it can be finalized.

Feedback is requested from regulators if a disclosure of the volume of contracts affected by LIBOR would be beneficial. While ASU 2020-04 did not contain significant disclosure requirements, the results of any SAP disclosure would not be able to ascertain the magnitude of the contract value affected by electing the optional expedient and exception guidance, however, could contain the items such as contact count and notional value.

Staff Review Completed by: Jim Pinegar, NAIC Staff – March 2020

Status:

On March 26, 2020, the Statutory Accounting Principles (E) Working Group conducted an email vote to expose INT 20-01T: *ASU 2020-04 - Reference Rate Reform*.

On April 15, 2020, the Statutory Accounting Principles (E) Working Group adopted, as final, Interpretation 20-01: *ASU 2020-04 – Reference Rate Reform* allowing temporary (optional) expedient and exception interpretative guidance, with a sunset date of December 31, 2022. These optional expedients would allow entities (under certain circumstances) to avoid having to remeasure contracts or reassess a previous accounting determination for hedged items.

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