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

**Issue:** ***ASU 2021-01, Reference Rate Reform***

**Check (applicable entity):**

| | P/C | Life | Health |
|---|---|---|---|
| Modification of Existing SSAP | ☒ | ☒ | ☒ |
| New Issue or SSAP | ☐ | ☐ | ☐ |
| Interpretation | ☐ | ☐ | ☐ |

**Description of Issue:**
In March 2020, 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* to ensure the financial reporting of hedging relationships would reflect a continuation of the original contract and hedging relationship during the period of the market-wide transition to alternative reference rates – commonly referred to as "reference rate reform." 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.

As is often the case with hedge accounting, 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. However, ASU 2020-04 provides temporary, optional, and expedient relief in that a qualifying modification (because 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. In essence, when a modification (because of reference rate reform) is made to a hedge's critical terms, a reporting entity can continue hedge accounting rather than dedesignate the hedging relationship. For fair value hedges, a reporting entity may change the hedged risk to another permitted benchmark interest rate without dedesignating the relationship; that is if the hedge is expected to remain highly effective in offsetting changes in fair value attributed to the revised hedged risk. For cash flow hedges, a reporting entity may change to another permitted benchmark interest rate without dedesignating the relationship if the forecasted hedge transaction remains probable of occurring.

The derivatives market continues to undergo various other transitions due to reference rate reform initiatives, specifically changing the reference rates used for margining, discounting, or contract price alignment (this change is referred to as a "discounting transition"). While these changes are related to reference rate reform, they are not modifying an interest rate that is expected to be discontinued (e.g., LIBOR). The most prevalent example of a discounting transition occurred in October of 2020 with Central Clearing Parties (CCP). In October of 2020, the CME Group switched to using the Secured Overnight Financing Rate (SOFR) from the Effective Federal Funds Rate (EFFR) to discount, margin and price align most U.S. Dollar based derivative products. A change in the discount rate results in an immediate increase or decrease in a derivative's fair value, which can affect required variation margin payments. In addition, using SOFR instead of EFFR impacts the amount of interest an entity will pay or receive in the related cumulative variation margin. Questions arose in that if a change in these terms would require hedge dedesignation, or if these situations should be afforded the relief offered in ASU 2020-04.

In January 2021, FASB issued *ASU 2021-01, Reference Rate Reform* to clarify that all derivative instruments affected by changes to the interest rates used for discounting, margining or contract price alignment (regardless of whether they reference LIBOR or another rate that is expected to be discontinued as a result of reference rate reform) are in scope of Topic 848. In short summary, for all derivatives affected by the discounting transition, entities may apply the optional expedients and the continuation of contract exceptions allowed in ASU 2020-04.

 

ASU 2021-01 expands the scope of ASU 2020-04 by allowing an entity to apply the optional expedients, by stating that a change to the interest rate used for margining, discounting or contract price alignment for a derivative is not considered to be a change to the critical terms of the hedging relationship that requires dedesignation. The entity may apply the contract modification relief provided in ASU 2020-04 and continue to account for the derivative in the same manner that existed prior to the changes resulting from reference rate reform or the discounting transition.

**Other Items:**
The discounting transition previously discussed was primarily driven by CCPs. In October of 2020, CCPs converted open derivative end-of-day valuation calculations from EFFR to SOFR. The process entailed CCPs conducting a standard end-of day valuation cycle based on EFFR. Then, CCPs conducted a special valuation cycle on those same positions, however utilizing SOFR as the new, ongoing discounting rate. Based on the differences between EFFR and SOFR, the CCP issued variation margin adjustments to offset the value differences arising from the change in discount rates. In addition to variation margin adjustments, CCPs issued mandatory EFFR/SOFR basis swaps, thus restoring the account holder's original risk profile. ASU 2021-01 provides guidance for the final settlement of cashflows stating that fair value hedges may adjust the fair value hedge basis while cash flow hedges may adjust accumulated other comprehensive income. The accounting, reporting, and admittance of basis swaps was previously addressed by the Working Group in *INT 20-09: Basis Swaps as a Result of the LIBOR Transition* and is further discussed in the "Activities to Date" section of this agenda item.

Informal note, feedback received from interested parties indicates that most basis swaps were liquidated prior to year-end 2020.

Finally, the effective date of ASU 2021-01 mimics the effective date of ASU 2020-04 in that the optional, expedient guidance may be applied from the beginning of an interim period that includes or is after March 12, 2020 and terminates December 31, 2022.

**Existing Authoritative Literature:**

ASU 2021-01 effectively increases the scope of the optional, expedient accounting guidance for derivative instruments in ASU 2020-04. Accordingly, only applicable derivative authoritative literature will be shown below. While detailed in the original agenda item (Ref #2020-12), additional SSAPS impacted by ASU 2020-04 were *SSAP No. 15—Debt and Holding Company Obligations* and *SSAP No. 22R—Leases.*

The modifications in ASU 2020-04 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 to 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—Derivatives*

> 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):**

The Working Group has taken several actions related to reference rate reform; each are summarized below.

1. 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.

2. Agenda item 2020-12 reviews ASU 2020-04, the foundation of which this agenda item and related ASU (2021-01) are based. Agenda item 2020-12 resulted in the Working Group adopting INT 20-01.

3. *INT 20-01: ASU 2020-04 - Reference Rate Reform*, adopted by the Working Group in April 2020, broadly adopted ASU 2020-04 for statutory accounting stating that for statutory accounting:

    - For all contracts within scope of ASU 2020-04, modifications due to reference rate reform are afforded an optional expedient to be accounted for as a continuation of the existing contract.
    - Debt and service agreement modifications, as a result of reference rate reform, should not typically rise to the level of requiring a reversal and rebooking of the liability, as *SSAP No. 15—Debt and Holding Company Obligations* states such liabilities should only be derecognized if extinguished.
    - Lease modifications, solely caused by reference rate reform and ones eligible for optional expedience, likely do not rise to the level of a modification requiring re-recognition as a new lease under *SSAP No. 22R—Leases.*
    - For derivative transactions within scope of ASU 2020-04, a change to the critical terms of the hedging relationship (due to reference rate reform), shall be afforded similar treatment in that the hedging relationship can continue the original hedge accounting rather than dedesignate the hedging relationship.

4. *INT 20-09: Basis Swaps as a Result of the LIBOR Transition*, adopted by the Working Group in July 2020, provided statutory accounting and reporting guidance for basis swaps issued by CCPs. This INT designated that basis swaps, issued by CCPs, in response to reference rate reform (i.e., the discounting transition), shall be classified as a derivative used for hedging. This categorization allowed for the basis swap derivatives to be admitted under SSAP No. 86. Additionally, the INT directed that basis swap derivatives shall not be reported as "effective" unless the instrument qualifies, with the required documentation, as highly effective under SSAP No. 86

**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).

**NAIC Staff Recommendation:**
**NAIC 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 an expiration date of December 31, 2022. These optional expedients would expand the current exception guidance provided by *INT 20-01: ASU 2020-04 - Reference Rate Reform*. With this guidance, derivative instruments affected by changes to the interest rates used for discounting, margining or contract price alignment (regardless of whether they reference LIBOR or another rate that is expected to be discontinued as a result of reference rate reform) would be in scope of INT 20-01. This exception would allow for continuation of the existing hedge relationship and thus not requiring hedge dedesignation.**

The proposed modifications to INT 20-01 temporarily override SSAP No. 86 guidance 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.

**Staff Review Completed by:** Jim Pinegar, NAIC Staff – January 2021

**Status:**
On March 15, 2021, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed temporary (optional) expedient and exception interpretative guidance, with an expiration date of December 31, 2022. These optional expedients would expand the current exception guidance provided by *INT 20-01: ASU 2020-04 – Reference Rate Reform*. With this guidance, derivative

instruments affected by changes to interest/reference rates because of reference rate reform (regardless of whether they reference LIBOR or another rate that is expected to be is discontinued), in which are used for discounting, margining or contract price alignment would be in scope of the exception guidance afforded in INT 20-01. This exception would allow for continuation of the existing hedge relationship and thus not requiring hedge dedesignation.

On May 20, 2021, the Statutory Accounting Principles (E) Working Group adopted, as final, the exposed revisions, which incorporated proposed interested party edits, to *INT 20-01: ASU 2020-04, Reference Rate Reform.* The revisions expand the current exception guidance provided in the INT and provide additional temporary (optional) expedient and exception interpretative guidance, with an expiration date of December 31, 2022. With this guidance, derivative instruments affected by changes to the interest rates used for discounting, margining or contract price alignment (regardless of whether they reference LIBOR or another rate that is expected to be discontinued as a result of reference rate reform) will be in scope of INT 20-01. This exception will allow for continuation of the existing hedge relationship and thus not require hedge dedesignation. This INT is all-encompassing for "any hedging relationships" within the scope of the interpretation and captures all hedging transaction types, regardless of if the transaction occurred bilaterally or through a central clearing party.

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