

Interpretation of the Statutory Accounting Principles (E) Working Group

INT 20-09: Basis Swaps as a Result of the LIBOR Transition

INT 20-09 Dates Discussed

Email Vote to Expose July 15, 2020; July 30, 2020

INT 20-09 References

Current:

SSAP No. 86—Derivatives

INT 20-09 Issue

1. This interpretation is to provide statutory accounting and reporting guidance for “basis swaps.” Basis swaps within the scope of this interpretation are defined as compulsory derivatives issued by Central Clearing Parties (CCP), for certain cleared derivatives, issued solely in response to the market-wide transition away from the London Interbank Offered Rate (LIBOR) and toward the Secured Overnight Financing Rate (SOFR).
2. SOFR is a broad measure of the cost of borrowing cash overnight, generally collateralized by Treasury Securities. It represents nearly a risk-free rate that is correlated with other money market rates and is fully transaction based (thus ensuring full transparency), by reflecting a broad measure of overnight U.S. Treasury repurchase transactions. In conjunction with the transition from LIBOR, many alternative reference rates, such as the Effective Federal Funds Rate (EFFR), an interest rate typically utilized by banks representing a charge for overnight loans, used to meet regulatory reserve requirements, are also being transitioned to SOFR. Accordingly, under the general topic referred to as “Reference Rate Reform,” contracts which reference or utilize LIBOR or EFFR, are anticipated to be modified to reference SOFR.
3. The Working Group previously adopted *INT 20-01: Reference Rate Reform*, which substantially adopted *ASU 2020-04 – Reference Rate Reform* and applies to all SSAPs with contracts within scope of ASU 2020-04. INT 20-01 allows for contract modifications, due to reference rate reform, to be accounted for as a continuation of the existing contract and thus not requiring remeasurement. Among other things, INT 20-01 allows for 1) certain hedging relationships to continue without requiring dedesignation upon a change in certain critical terms (i.e. changing reference rates), and 2) changes in the designated benchmark interest rate to a different eligible benchmark interest rate in a fair value hedging relationship. INT 20-01 recognized that many of these contracts, as part of the discontinuance of LIBOR, will transition to SOFR, an industry recognized preferred benchmark rate.
4. CCPs will make a similar transition, converting open derivative end-of-day valuation calculations from EFFR to SOFR. This transition will occur in two steps, both of which are anticipated to occur on October 16. First, the CCPs will conduct a *standard end-of-day valuation cycle* based on EFFR. Then, the CCP will conduct 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 will issue cash adjustments to each account to offset the value adjustments arising from the change in discount rates and additionally will issue mandatory EFFR/SOFR basis swaps, thus restoring the account holder’s original risk profile.
5. *SSAP No. 86—Derivatives* addresses the recognition and measurement of derivatives used for hedging, income generation, and replication transactions. Additionally, guidance is provided for derivatives not utilized for one of these broad categories (known as “other derivatives”). Derivatives that are classified as “other derivatives” are nonadmitted under SSAP No. 86, whereas derivatives in the other categories are admitted provided they conform to the requirements of the statement.

6. The accounting issues are:
 - a. Issue 1: How should EFFR/SOFR basis swaps be classified and reported in the statutory financial statements?
 - b. Issue 2: How should EFFR/SOFR basis swaps be valued in the statutory financial statements?

INT 20-09 Discussion

7. For Issue 1, the Working Group reached a consensus that mandatory basis swaps issued by CCPs, in response to reference rate reform, shall be classified as a derivative used for “hedging.” In collaboration with industry representatives, Working Group support staff has confirmed that a significant majority of the derivatives transacted through a CCP meet the definition of a hedging transaction. By using this “used for hedging” classification, instead of an “other derivative” classification, the basis swap derivative received will be admitted under SSAP No. 86.

8. For Issue 2, the Working Group reached a consensus that although the instrument shall be considered a hedging derivative, the instrument shall not be considered or reported as an “effective” hedging derivative (using the “hedge accounting” measurement approach permitted in SSAP No. 86), unless the instrument qualifies, with the required documentation, as a highly effective hedge under SSAP No. 86. Unless the effective hedge requirements are met, the instruments shall be reported on Schedule DB, utilizing the category of “Hedging Other.” Pursuant to the guidance in SSAP No. 86, if the basis swap derivative is not an effective hedge, the derivative shall be accounted for at fair value and the changes in fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting.)

INT 20-09 Status

8. No further discussion is planned.