NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research — Capital Markets Special Report

The NAIC's Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the INDEX.

# The LIBOR Phase Out and Transition: Frequently Asked Questions (FAQ)

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### Q: What is LIBOR?

A: LIBOR stands for the London Interbank Offered Rate, and it is the primary benchmark for short-term and variable interest rates used to determine interest rates on a variety of financial instruments. LIBOR rates are calculated for five currencies—USD (U.S. Dollar) LIBOR, GBP (Sterling) LIBOR, EURIBOR (Euro), JPY (Japanese Yen) LIBOR, and CHF (Swiss Franc) LIBOR—with a term structure ranging from overnight to one year.

### Q: Why is LIBOR being phased out?

A: The financial markets will be transitioning away from using LIBOR as a reference benchmark given concerns about the integrity and validity of the data reported by banks following the financial crisis. LIBOR is calculated from 20 banks' estimate of funding costs, or the rate one would be charged if it were to borrow from another bank. Several banks had allegedly manipulated LIBOR by reporting inaccurate quotes over a period of time.

### Q: When will LIBOR be phased out?

A: By the end of 2021, Britain's Financial Conduct Authority (FCA) will no longer require banks to provide quotes used to calculate LIBOR. No specific "end" date has been provided, but initiatives are underway to establish an alternative reference rate.

### Q: Is there a replacement for LIBOR?

A: In the U.S., the Alternative Reference Rates Committee (ARRC), a group of private market participants brought together by the Federal Reserve Board and the New York Fed, was created to ensure a successful transition from LIBOR. The ARRC's recommended alternative reference rate for the U.S. is the Secured Overnight Financing Rate (SOFR), which is based on the cost of overnight loans—or repurchase agreements (repos). Other countries are developing comparable reference rates. Unlike LIBOR, SOFR will be based on actual market transactions that are observable, transparent and verifiable. Many financial entities, including insurance companies, use repos to borrow cash overnight using primarily U.S. government debt as collateral.

The market for derivative products tied to SOFR is developing. The average daily volume of SOFR futures contracts has increased by approximately 75% since 2019, according to the CME Group. Furthermore, in January 2020, the CME Group began offering options on SOFR interest rate futures.

For more information on SOFR, please refer to [A User's Guide to SOFR] from the ARRC.

Q: Which financial instruments will be affected by the transition away from LIBOR?

A: LIBOR is used in a large volume and broad range of financial products and contracts within a variety of markets, including business and consumer lending. According to the ARRC, approximately $200 trillion of financial products and contracts referenced USD LIBOR as of year-end 2016, with derivatives accounting for 95% of the total.

Corporate bonds, structured bonds, home mortgages, business loans and derivative contracts typically use LIBOR as a pricing benchmark. Structured bonds such as asset-backed securities (ABS), residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralized loan obligations (CLOs), and collateralized debt obligations (CDOs) are priced using LIBOR. The following table provides a summary of products indexed to LIBOR:

| Product | Product examples |
|---|---|
| • OTC derivatives | • Interest rate swaps, FRAs, cross-currency swaps |
| • ETDs | • Interest rate options, Interest rate futures |
| • Loans | • Syndicated loans, business loans, mortgages, credit cards, auto loans, consumer loans, student loans |
| • Bonds and FRNs | • Corporate and non-US government bonds, agency notes, leases, trade finance, FRNs, covered bonds, capital securities, perpetuals |
| • Short-term instruments | • Repos, reverse repos, time deposits, CDS, commercial paper |
| • Securitized products | • MBS, ABS, CMBS, CLO, CMO |
| • Other | • Late payments, discount rates, overdraft |

Note: ETDs = Exchange-Traded Derivatives
Source: American Council of Life Insurers

Q: How will the LIBOR phase out and transition affect U.S. insurance companies?

A: Due to the broad use of LIBOR as a reference rate, all financial market participants, including insurance companies, are affected by the risks associated with the transition. Insurance companies should be monitoring developments related to the LIBOR transition to fully understand and prepare for the impact on their business, financial investments, customers and counterparties.

A key issue that will arise from the transition on the asset side (e.g., bonds, short-term instruments, securitized products) is the need to review, and potentially revise, all financial agreements and contracts that reference LIBOR. They can be amended to refer to a different benchmark rate and/or incorporate "fallback language" provisions. For derivative contracts that are cleared through an exchange, the transition to LIBOR will result in a basis swap to account for the difference between how LIBOR and, in this case, SOFR are calculated. Therefore, insurance companies may be entered into this new transaction by the clearinghouse. However, it is unclear if the basis swap would qualify as one of the allowed uses of derivatives—hedging, replication or income generation.

On the product side, insurance companies may also need to consider making changes to policy forms for annuities and other policies that contain guaranteed rates that reference LIBOR. On the liabilities side, the benchmark rate for determining life and annuity reserves needs to be revised in the *Valuation Manual* with the transition away from LIBOR.

### Q: What is "fallback language"?

A: "Fallback language" refers to legal provisions that apply if the underlying reference rate in the contract is discontinued or unavailable. The ARRC released recommendations on fallback language to incorporate in new financial contracts that reference USD LIBOR for market participants' voluntary use. It provided recommended fallback language for five cash products: 1) adjustable-rate mortgages (ARMs); 2) bilateral business loans; 3) floating rate notes (FRNs); 4) securitizations; and 5) syndicated loans.

The ARRC has also been working with the International Swaps and Derivatives Association (ISDA) in considering best practices for fallback language in derivatives contracts.

### Q: Which party can change the terms (e.g., benchmark rate and/or fallback language) of an existing contract?

A: Required consent depends on the type of financial instrument. Some contracts require all parties to consent to a change in the contract, while others allow one party to make a change without the consent of the other party(ies). Standard & Poor's Financial Services LLC (S&P) provides a summary of the consent required by asset in the following chart:

**Consent By Contract**

| | Consent Required |
|---|---|
| Business loans | - Bilateral negotiation b/w borrower and lender<br>- Syndicated loans: Unanimous consent |
| Bonds (FRNs) | - Unanimous consent of note holders |
| Securitized Products (1) | - Agency MBS and CMO: Issuer decides<br>- Non Agency: Noteholder vote; typically unanimous<br>- CLO: Unanimous consent |
| Mortgages/consumer loans | - Noteholder chooses |

Source: "Second Report", Alternative Reference Rates Committee, March 2018.
(1) Securitized Products include MBS & CMOs, CLOs, ABS, and CDOs


For derivatives contracts that are traded on exchanges, ISDA is working to enhance the contractual robustness of derivatives contracts to address the end of LIBOR. It has identified SOFR as the appropriate reference benchmark rate, but it is still finalizing the fallback language to be incorporated into exchange-traded derivatives (ETDs) contracts.

Q: How will the NAIC address the LIBOR transition issues affecting U.S. insurance companies?

A: The NAIC will be working with state insurance regulators and interested parties to address all key issues arising from the LIBOR transition. The Financial Stability (EX) Task Force will coordinate and oversee the work, liaising with the appropriate task forces, working groups, state insurance regulators, and industry. The Life Actuarial (A) Task Force will address the issues related to policy forms and life/annuity reserving. The Valuation of Securities (E) Task Force will address the investment, derivatives and basis swap issues.

Q: What is the U.S. insurance industry's exposure to financial products that reference LIBOR?

A: The Capital Markets Bureau will be providing the industry's exposure to LIBOR after annual statement filings for year-end 2019 are completed.

Q: Are there any statutory accounting considerations as a result of the transition to a new benchmark rate?

A: In April 2019, the Statutory Accounting Principles (E) Working Group revised *SSAP No. 86—Derivatives* to add the SOFR Overnight Index Swap (OIS) and the Securities Industry and Financial Markets (SIFMA) Municipal Swap Rate as U.S. benchmark interest rates for hedge accounting. The Working Group will also consider new Financial Accounting Standards Board (FASB) guidance (once issued) to provide exceptions to derivative derecognition (and other affected structures) to allow for a smooth transition to a new referenced rate.

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