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Structured Products Association

2022 Structured Products Legal, Regulatory & Compliance Series

Recent NAIC Developments and LIBOR Transition Developments

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Moderated by

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Agenda

Opening Remarks ▪ 4:30pm – 4:35pm EST

PANEL 1 ▪ 4:35pm – 5:25pm EST

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Recent NAIC Developments

- Status of Revisions to the NAIC Bond Definition
- Principal Protected Notes Securities Guidance
- Other NAIC Developments

PANEL 2 ▪ 5:25pm – 6:15pm EST

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LIBOR Transition Developments

- Status of the Transition/Cessation of IBORs
- ISDA Definitions
- Addressing CMS
- Replacing LIBOR in Indices
- Final Tax Regulations

Closing Remarks ▪ 6:15pm – 6:20pm EST

PANEL 1

Recent NAIC Developments

Changes to the Rules on "What is a Bond" are Still Being Hammered Out

- The principles-based approach originally proposed in October 2020 by staff of the Iowa Insurance Division has won the day
- It has become the basis for the revisions to *SSAPs No. 26R (Bonds)* and *43R (Loan-Backed and Structured Securities)* that are currently being developed by the NAIC Statutory Accounting Principles (E) Working Group
- The earliest projected implementation date is January 1, 2024

Overview of the Emerging Definition

- A "bond" is a security
  - representing a creditor relationship,
  - whereby there is a fixed schedule for one or more future payments, and
  - which qualifies as either:
    - an issuer credit obligation, or
    - an asset backed security ("ABS")

Issuer Credit Obligations

- An **issuer credit obligation** is a bond, the repayment of which is supported primarily by the general creditworthiness of an operating entity or entities
- Issuers can be either operating companies or holding companies that have the ability to access the cash flows of operating company subsidiaries through their ownership rights
- The definition of operating companies is still being worked on
  - For example, the draft proposal in May 2021 included 1940 Act registered investment companies, but not private funds

Asset-Backed Securities

- An **ABS** is defined as:
  - A bond issued by an entity (an "ABS Issuer") created for the primary purpose of raising debt capital,
  - backed by financial assets or cash generating non-financial assets owned by the ABS Issuer,
  - whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity.

Conditions ABS Must Satisfy to be a "Bond"

Condition #1:

- The assets owned by the ABS Issuer must be either:
  - financial assets, or
  - cash-generating non-financial assets
    - Defined as assets that are expected to generate a "meaningful" level of cash flows toward repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation (and not just through the sale or refinancing of the assets)
    - "Meaningful" criterion is deemed met if less than 50% of the original principal relies on sale or refinancing, but can also be met in other ways

Condition #2:

- The holder of a debt instrument issued by an ABS Issuer must be:
  - in a different economic position than if the holder owned the ABS Issuer's assets directly
  - as a result of "substantive" credit enhancement through:
    - guarantees (or other similar forms of recourse),
    - subordination and/or
    - overcollateralization.

Treatment of Feeder Fund Rated Debt

- One example given in the May 2021 proposal describes a typical rated private equity feeder structure in which each investor
  - owns a pro rata share of the unsecured debt investments and equity interests outstanding and
  - is restricted from selling, assigning or transferring all or part of the unsecured debt investment without also selling, assigning, or transferring a corresponding portion of the equity interest to the same party
- The drafters conclude that the debt investment does not have the required creditor relationship
- It would appear from the example that in a case where the debt and equity investments are not "stapled" (*i.e.*, one can be sold without the other) a different conclusion may apply

More Granular RBC Factors Now in Effect

- The credit quality of an insurer's bond or preferred stock investment is signified by a "designation" (essentially equivalent to a rating) with NAIC-1 indicating the lowest and NAIC-6 the highest credit risk
  - An NAIC-1 covered the entire range from AAA/Aaa to A–/A3
- RBC factors associated with insurer investments are determined by the NAIC designations
- Several years ago, the NAIC increased the granularity of its designations by sub-dividing the designations into 20 categories matching the notched ratings of NRSROs
- However, the RBC factors did not become more granular until 2021

Impact of the More Granular RBC Factors

- Effective with the 12/31/21 statutory statements, RBC factors have been assigned for each of the 20 more granular categories
- To illustrate the impact, prior to 2021 the pre-tax RBC factor for a life insurer was 40 bps for an NAIC-1 investment, regardless of category
- That RBC factor is now:
  - 15.8 bps for an NAIC 1.A investment (equivalent to AAA/Aaa)
  - 101.6 bps for an NAIC 1.G investment (equivalent to A–/A3)
- To the extent that life insurers have invested at the lower end of a designation, the new more granular RBC factors will produce an immediate increase in the RBC factors applicable to those investments and will increase required RBC and exert downward pressure on their RBC ratios in the near term

New Filing Requirement for Securities with Private Letter Ratings

- On May 24, 2021, the NAIC Valuation of Securities (E) Task Force ("VOS TF") adopted revisions to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the "*P&P Manual*")
- Effective on January 1, 2022, as a general rule, insurers that invest in securities that have a private letter rating are required to provide the NAIC's Securities Valuation Office ("SVO") with a copy of the related **private rating letter rationale report** from the applicable NAIC-recognized credit rating provider ("CRP")

What Is a "Private Letter Rating Rationale Report"?

- "Private rating letter rationale report" means:
  - an analytical review of the privately rated security explaining the transaction structure, methodology relied upon, and, as appropriate, analysis of the credit, legal and operational risks and mitigants supporting the assigned rating
  - in a report issued by a CRP on its letterhead or its controlled website to an issuer or investor,
  - obtained by an insurer in its capacity as an investor in the issuance or by following the confidentiality process established by the CRP.
- A private rating letter rationale report is expected to mirror the work product that a CRP would produce for a similar publicly rated security.

New SVO "Checkpoint" Now in Effect

- When a private rating letter rationale report is filed for a security, the SVO will now evaluate whether the private letter rated security is eligible to receive an NAIC designation with a CRP credit rating
- In other words, the SVO will evaluate:
  - whether the security is a fixed-income security eligible for reporting on Schedule D, and
  - if so, whether it is eligible for a filing exemption
- The revisions did not change the standards for answering those two questions, but have established a "checkpoint" whereby each private letter rated security will now be examined by an SVO analyst to determine whether it satisfies those two criteria

Refresher on the PPS Filing Regime

- On May 14, 2020, the VOS TF amended the P&P Manual to include a new definition of "**principal protected securities**" ("PPS") that, as of January 1, 2021, have been **removed from the filing-exempt category** and need to be filed with the SVO for analysis and the assignment of an NAIC designation, rather than automatically receiving a designation based on a CRP rating
- There is **no "grandfathering"** – the new treatment applies to all PPS held by insurers in the 12-31-21 statutory statements

The PPS Definition is Complex

- A PPS is "a type of security that **repackages** one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) (including principal and, if applicable, interest, make whole payments and fees thereon) that if purchased by an insurance company on a stand-alone basis would be eligible for Filing Exemption" and for which two additional conditions are satisfied (*see next slide*).

Two Additional Conditions for a PPS

In addition to the first part of the definition mentioned previously, **both** of the following conditions must be fulfilled:

1. The insurer would obtain a more favorable RBC charge or regulatory treatment for the PPS through filing exemption than it would if it were to separately file the underlying investments in accordance with the P&P Manual

   and

2. **Either**:
   - The repackaged security structure enables potential returns from the underlying investments in addition to the contractually promised cash flows paid to such repackaged security according to a fixed schedule; or
   - The contractual interest rate paid by the PPS is zero, below market or, in any case, equal to or below the comparable risk-free rate

SVO Seeks to Apply "Principal Protected Security" Definition to Structured Notes

- We use the term "**structured note**" to refer to:
  - a debt security issued by a financial institution
  - that obligates the issuer to pay
    - principal at maturity
    - plus a premium return based on the performance of an index, which may be comprised of equities, fixed-income instruments, futures or other financial assets

Reasons for Excluding Structured Notes from the Definition of PPS

- In contrast to the examples of PPS in the *P&P Manual*, which involve repackaging of underlying assets, there is no literal repackaging of underlying assets in an SPV structure
- The structured note is not the obligation of an SPV that holds underlying assets, but of a substantial financial institution.
- There has therefore been a hope that this type of structured note could avoid being classified as a PPS

SVO Staff Proposal Would Amend PPS Definition to Include Structured Notes

- At the December 12, 2021 VOS TF meeting, the SVO staff presented a recommendation that the VOS TF amend the definition of PPS in the *P&P Manual* to include these types of structured notes, as well
- The rationale is that in the SVO staff's opinion a structured note with a variable return tied to reference assets poses similar risks to PPS that utilize a "repackaging" SPV structure with underlying performance assets
- The VOS TF voted to expose the SVO staff's recommendation for a comment period ending on February 11, 2022

Potential Impact of the Loss of Filing Exemption for PPS

- In the SPV structure, a PPS with an underlying US Treasury zero coupon bond and performance assets linked to the S&P 500 Index would have a CRP rating of AAA/AA+ or an NAIC 1.A, based solely on the risk of the US Treasury bond
  - Resulting RBC factor = 0.158%
- In contrast, the Weighted Average Ratings Factor ("WARF") methodology applied by the SVO would result in an NAIC 4.B when it includes the exposure to the call options on the S&P 500 Index
  - Resulting RBC factor = 9.535%
- It is not clear that a structured note, if treated as a PPS, would be analyzed the same way, but it might

New RBC Investment Risk and Evaluation (E) Working Group Established

- Reports to the Capital Adequacy (E) Task Force
- Charged with performing a comprehensive review of the RBC investment framework for all business types, which could include:
  - Identifying and acknowledging uses that extend beyond the purpose of the Risk-Based Capital ("RBC") for Insurers Model Act
  - Assessing the impact and effectiveness of potential changes in contributing to the identification of weakly capitalized companies; *i.e.*, those companies at action level
  - Documenting the modifications made over time to the formulas, including, but not limited to, an analysis of the costs in study and development, implementation (internal and external), assimilation, verification, analysis, and review of the desired change to the RBC formulas and facilitating the appropriate allocation of resources.

Request for Comment at First Meeting of the New Working Group on January 12, 2022

- Feedback solicited regarding the review of the RBC treatment of ABS including collateralized loan obligations (“CLOs”), collateralized fund obligations (“CFOs”) or other similar securities carrying similar types of “tail risk”:
  - Methodologies for capturing the risk (including tail risk) that exists with such assets (*e.g.*, ratings-determined bond factors, a modeling process akin to the current CMBS/RMBS approach, or other proposals)
  - How a consultant or consulting actuary could be used by the NAIC to determine the appropriate charge based upon certain data
  - The need for review outside of Life RBC (*i.e.*, Health and P&C)
  - Whether residual tranches in ABS structures can be evaluated in conjunction with and under similar methodologies as the debt tranches
  - Specific proposals for addressing RBC treatment of residual tranches to reduce arbitrage incentives

NAIC Investment Analysis Office Analyzes Variability in Ratings

- At the December 12, 2021 VOS TF meeting, the VOS TF received a memorandum from senior staff of the Investment Analysis Office ("IAO") reiterating the IAO's long-held concerns about CRP ratings
- The memorandum included reports on:
  - An SVO staff review of a sample of privately rated securities, where the NAIC designations equivalent to the CRP's rating differed significantly from the staff's own analysis (being 3 to 6 notches higher than staff's estimates)
  - An IAO analysis of both publicly rated and privately rated securities, showing significant rating notch differences between CRPs that rated the same security

Four Potential Alternative Remedies the IAO Would Like the VOS TF to Consider

- Require at least two (or more) CRP ratings for every security and use the lowest rating to determine the NAIC designation
  - If a security has only one rating, require it to be reviewed by the SVO to determine whether the SVO deems the rating reasonable (i) pursuant to its own analysis, (ii) when benchmarked to NRSRO peers and methodology, or (iii) compared to a spread implied rating, and, if not, to determine whether a full filing and SVO analysis would be appropriate
- Conduct an in-depth study of the NAIC's use of CRP ratings and SVO-assigned NAIC designations as to their consistency and comparability for regulatory purposes, specifically the determination of RBC factors
- Require CRPs to be vetted through a request for qualifications (RFQ) process, similar to the RFP process for CMBS/RMBS
- Consider removing a rating agency from the CRP list if deemed appropriate

Status of the IAO Memorandum

- The VOS TF did not take any action on the IAO memorandum at the December 12, 2021 meeting other than to receive it as a starting point for discussion in 2022
- In other words, the IAO memorandum has not even been exposed for public comment – it is just a potential starting point for discussion by the VOS TF
- That discussion will be conducted under the auspices of the new VOS TF chair, Carrie Mears of the Iowa Insurance Division, and will likely involve input from industry representatives as well as VOS TF members and other regulators

Renewed Scrutiny of Private Equity Ownership of Insurers

- In a September 30, 2021 presentation to the NAIC Financial Stability (E) Task Force (the "FS TF"), Eric Kolchinsky, Director of the Capital Markets Bureau and the SSG, asserted that PE-owned insurers present "novel regulatory risks":
  - PE-owned insurers focus far more on investing in ABS than do traditionally owned insurers
  - PE firms seek to extract value from PE-owned insurers via asset management fees rather than dividends and salaries, and they use affiliate transactions to do so

Concerns Expressed About Affiliate Transactions

- A PE firm may set up an SPV (a "first degree affiliate"), managed by an affiliate of the PE firm, that issues CLOs or other structured products in which the PE-owned insurer invests. Mr. Kolchinsky asserted that it is "common" for insurers to report such arrangements as unaffiliated investments
- A PE-owned insurer may invest in CLOs or CFOs that hold debt and equity of "second degree affiliates" of the insurer (*i.e.*, other portfolio companies of the PE firm that controls the insurer). Mr. Kolchinsky referred to one example where 70% of CLOs held by an insurer had some exposure to its PE owner's portfolio companies

Macroprudential Working Group (E) Tasked with Addressing Issues of PE Ownership

- The FS TF delegated responsibility for considering issues raised by PE ownership of insurers to its Macroprudential (E) Working Group ("MWG")
- On December 7, 2021, the MWG exposed for comment an initial draft list of "regulatory considerations" applicable to PE-owned insurers, for a comment period ending on January 18, 2022
- At its meeting on February 1, 2022, the MWG made some revisions to the document based on comments received and voted to adopt the revised document and send it "up the ladder" to the FS TF

Regulatory Considerations Applicable (but Not Exclusive) to PE-Owned Insurers

- The document adopted by the MWG lists 13 regulatory considerations, many of them overlap, of which key points are:
  - Regulators may not be obtaining clear pictures of risk due to holding companies structuring contractual agreements in a manner to avoid regulatory disclosures and requirements
  - Control and conflict of interest considerations may exist even where there is ownership below the 10% level, due to board and management representation or contractual arrangements
  - Investment management agreements may include onerous or costly termination provisions, or excessive control or discretion given over investment guidelines, allocation and decisions
- Owners may be focused on short-term results, which may not be in alignment with long-term nature of liabilities in life insurance products
  - Investment management fees, when not “fair and reasonable,” could be a “disguised dividend”
  - Owners may not be willing to transfer capital to a troubled insurer
- Owners of insurers may not have the correct priorities or appropriate experience and may delegate running the life insurance to third-party administrators who do not perform properly

Regulatory Considerations *(cont'd)*

- There is no uniform definition of PE and there are challenges with maintaining a complete list of insurers' material relationships with PE firms
- There is a lack of identification of related party-originated investments (such as structured securities), which may create potential conflicts of interests and/or hidden fees in the portfolio structure. Assets created and managed by affiliates may include fees at different levels of the value chain
- Underlying affiliated investments and/or collateral cannot be easily identified within structured security investments, for example, loans in a CLO issued by a portfolio company of a related PE firm
- There is a concern that disclaimers of affiliation can be used to avoid disclosure of related-party investments, although the new Schedule Y, Part 3, is addressing this issue by identifying all entities with 10% or greater ownership, regardless of disclaimers of affiliation

Regulatory Considerations *(cont'd)*

- There has been a material increase in privately structured securities, which introduce other sources of risk or increase traditional credit risk (such as complexity risk and illiquidity risk) and involve a lack of transparency
- The level of reliance on rating agency ratings and their appropriateness for regulatory purposes (*e.g.*, accuracy, consistency, comparability, applicability, interchangeability and transparency)
- The trend of life insurers in pension risk transfer (PRT) business to support such business with the more complicated investments outlined above.
- Insurers' use of offshore reinsurers (including captives) and complex affiliated sidecar vehicles to maximize capital efficiency, reduce reserves, increase investment risk and introduce complexities into the group structure

Status of the MWG's Regulatory Considerations

- For the most part, the foregoing list of regulatory considerations is just that – a list of concerns that the various units within the NAIC structure are expected to consider how to address
- In fact, the final version of the document adopted by the MWG is annotated with cross-references to numerous initiatives that other NAIC units have already been taking with respect to the various considerations
- However, some of the considerations listed are likely to spark new initiatives – and, one presumes, a response from the PE community challenging many of the assertions in the list of considerations and the underlying assumptions reflected in them

PANEL 2

LIBOR Transition Developments

LIBOR Transition Update

LIBOR cessation:

- All non-USD tenors and 1-week and 2-month USD LIBOR ceased publishing on December 31, 2021
- 17 months until total stop on USD LIBOR
- 3-month USD LIBOR and other USD LIBOR tenors will stop publishing after June 30, 2023

Legislation:

- Article 18-C of New York General Obligations Law
  - Solves for: USD LIBOR in New York law governed contracts
- Federal legislation passed the House, waiting for Senate
  - Solves for: Any state law governed contract with USD LIBOR
  - Will resolve USD LIBOR Delaware law trust preferred
- Between the cracks: GPB LIBOR in a New York law governed floating rate note
  - Why? Wrong currency
- Synthetic GBP LIBOR may help, depending on how the documents are written
- Otherwise, on to other solutions, like tender and exchange offers

The Banking Regulators Speak

- The interagency statement on LIBOR transition of November 30, 2020 stated that "banks" should not enter into new USD LIBOR contracts after December 31, 2021. In FN6, "new contracts" are defined as "new USD LIBOR lending; new USD LIBOR debt, preferred equity, or securitization issuance; and new USD LIBOR derivatives transactions."
  - Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency
- Some banks sell call options on indices with a USD LIBOR component, under existing contracts. Would writing these options under an existing contract constitute entering into a new USD LIBOR contract?
  - Questionable whether writing options on an index with a USD LIBOR component is a "new USD LIBOR contract"
  - These indices are not always in USD LIBOR

The Banking Regulators Speak *(cont'd)*

October 30, 2021 interagency statement:

- Added three more regulators
- In the new guidance, "new contracts" was expanded to include "an agreement that (i) creates additional LIBOR exposure for a supervised institution or (ii) extends the term of an existing LIBOR contract."
- The new guidance also states that "[a] draw on an existing agreement that is legally enforceable (*e.g.*, a committed credit facility) would not be viewed as a new contract."
- Not requiring supervised institutions to breach existing legally enforceable contracts.

Term SOFR

Term SOFR:

- Seemed like a great solution for a USD LIBOR replacement in floating rate notes
  - Forward-looking term rate, can calculate interest at the beginning of the interest period, just like USD LIBOR FRNs
- The ARRC does not recommend Term SOFR for initial issuances of floating rate notes
- Recommends Term SOFR for the first fallback in the ARRC-recommended USD LIBOR to SOFR fallback waterfall
- Also recommends Term SOFR as the first replacement rate that would be recommended by the ARRC under the NY LIBOR legislation

Replacing LIBOR in Indices

- Some indices with a volatility or risk control theme have a “cash” element, typically 3-month USD LIBOR. Some of the index methodologies for these indices have LIBOR fallback provisions to a replacement rate, while others would have to be amended to change out the USD LIBOR component.
- Each of S&P Dow Jones Indices LLC (“S&P”), MSCI Inc. and IHS Markit published consultations requesting feedback from market participants on an appropriate replacement rate. Wherever an IBOR was used in an index, the relevant risk-free replacement rate was suggested as an alternative. For example, the SOFR was the suggested replacement for USD LIBOR, while the Euro Short-Term Rate (“ESTR”) was suggested as a replacement for EURIBOR. The desirability of a forward-looking risk-free term rate was expressed in these consultations as a replacement for a similar tenor of the IBOR, while it was noted in at least one publication that daily SOFR would be a suitable replacement for overnight USD LIBOR.
  - MSCI announced on August 19, 2021 that it has amended eleven methodologies to replace LIBOR and EONIA in the MSCI indices.
  - S&P issued further consultation on July 28, 2021, in which it sought further market feedback and also stated that the IBOR replacements would be effective as of the October 2021 rebalancing. In that consultation, S&P stated that USD LIBOR would be replaced with SOFR, overnight and term.

What about CMS?

The USD LIBOR constant maturity swap rate:

- Has a USD LIBOR element (the floating rate leg – uses 3-month USD LIBOR)
- The administrator (Intercontinental Exchange) ("ICE") hasn't indicated if it will cease publication after 6/30/23
  - ICE ceased publication of the GPB LIBOR CMS rate on December 31, 2021
- ICE began publishing a SOFR CMS rate in November 2021
  - Had been published as a beta version prior to that date

What to do with existing CMS floating rate notes?

- The New York or federal legislation won't help
- Under older formulations, will become fixed rate notes
- Potential use of synthetic USD LIBOR – if and when published
  - Depends on description in the documents
- May have to consider other alternatives, such as tender or exchange offers
- ISDA has come out with robust fallbacks for newly issued USD LIBOR CMS rate notes and also SOFR CMS rate notes.

2021 ISDA Definitions and Floating Rate Descriptions

- On October 4, 2021, the 2021 ISDA Definitions came into effect. Note that we are now up to version 4.0 of the definitions book, dated December 16, 2021.
  - Always check the ISDA website for the latest version of any document
- **What is the effect on floating rate note descriptions?**
  - Polling is gone
  - All descriptions based on the 2006 ISDA Definitions are out of date
  - Robust fallback provisions put in place for the following USD rates:
    - Ameribor, BSBY, CMT, Commercial Paper, Credit Inclusive Term Rate (CRITR), Federal Funds, USD LIBOR, CMS (LIBOR), CMS (SOFR), Municipal Swap Index, Overnight Bank Funding Rate, Prime Rate, S&P Index High Grade, SOFR, Treasury Rate, plus variations
  - Avoids floating rate notes becoming fixed rate notes

PANEL 2 ▪ LIBOR TRANSITION DEVELOPMENTS

New US Federal Tax Guidance

Background

- In April 2019, the ARRC (and others) requested guidance from the US Treasury on the US federal tax consequences of replacing LIBOR
- In October 2019, the IRS released proposed regulations addressing IBOR replacement
- In October 2020, the IRS released Rev. Proc. 2020-44 with limited guidance for amending existing instruments
- On December 30, 2021, the IRS released **final regulations** making some helpful changes

Potential Deemed Exchange

- Does the change to an instrument's floating interest rate result in a "significant modification" under Treas. Reg. § 1.1001-3?
  - Concern exists for actual replacement of an IBOR pursuant to fallback provisions and the addition of IBOR fallbacks to an existing instrument
- If there is a "significant modification," potential deemed exchange

Significant Modification

- Is there a "modification"?
- Exceptions
  - Alterations pursuant to the terms of a debt instrument
  - Unilateral option of issuer or holder
- Is the modification "significant"?
- Multiple tests, but change in yield test most likely for alterations to floating interest rate
  - Change in yield - does annual yield on "new" instrument differ from yield on "old" instrument by more than the greater of (a) .25% or (b) 5% of the annual yield of the "old" instrument
- General facts and circumstances test

Consequences of Significant Modification

- Deemed exchange of the "old" note for the "new" note
- Potential for recognition of gain or loss to US holders
  - Gain (and potentially loss) equal to difference between issue price of the "new notes" and holder's adjusted tax basis
    - Issue price may be principal amount or FMV, depending on whether notes are treated as traded on an established market
  - Possible recapitalization for corporate debt
- Potential for original issue discount ("OID")
- Cancellation of indebtedness income for the issuer

Non-debt Contracts

- There are no clearly defined rules for amending non-debt contracts
- *Cottage Savings Association v. Commissioner*, 499 US 554, could be read to imply a "hair trigger" based on "legally distinct entitlements" standard

The Proposed Regulations

- Under Prop. Treas. Reg. § 1.1001-6, if terms of debt instrument were modified to:
  - Replace an IBOR rate with a "qualified rate"
  - To provide for a fallback for an IBOR rate with a "qualified rate"
  - To substitute a "qualified rate" in place of a rate referencing an IBOR rate as a fallback to another rate
- If those modifications met the requirements of the proposed regulations, then those modifications (and certain associated alterations and modifications) were not treated as modifications under Treas. Reg. § 1.1001-3
- Two requirements to be a "qualified rate":
  - Rate must be one of the enumerated qualifying rates
  - FMV of the instrument after the modification or alteration must be "substantially equivalent" to the fair market value of the instrument before the modification or alteration

Substantially Equivalent FMV

- In general, the fair market value of the instrument after the modification or alteration must be substantially equivalent to the fair market value of the instrument before the modification or alteration
- The proposed regulations include two safe harbors:
  - Historic average safe harbor
  - Arm's-length safe harbor

Rev. Proc. 2020-44

- Released on October 9, 2020
- Separate from the proposed regulations
- Provides retroactive but limited relief for amending specific types of legacy contracts to add fallback mechanics for LIBOR or other IBORs to include ARRC fallbacks or ISDA fallbacks

PANEL 2 ▪ LIBOR TRANSITION DEVELOPMENTS

The Final Regulations

Overview

- The fair market value equivalence standard is no more
- Through a "waterfall" of definitions, the final regulations contain a simple structure that blesses any modification to a contract that is a "covered modification," ***unless*** a portion of the modification is a "noncovered modification"
  - Applicable to all our favorites, including debt, stock, derivatives, insurance contracts, and leases
- The final regulations make clear the test applies both when a fallback is added and when/if the fallback is implemented
- Guidance for specific situations, instruments and taxpayers also included

What is a Covered Modification?

- If terms of an instrument are modified to:
  - Replace a “discontinued IBOR” rate with a “qualified rate” and any a “qualified one-time payment” made in connection with the replacement
  - To provide for a fallback for a “discontinued IBOR” rate with a “qualified rate”
  - To substitute a “qualified rate” in place of a rate referencing a “discontinued IBOR” rate in an existing fallback
- Also blessed are any “associated modifications” in connection with the above

What is a Covered Modification?
Defined Terms

- A "**discontinued IBOR**" is generally an interbank offered rate that has had the applicable administrator announce a plan to cease its publication (with no successor administrator taking over), and is not more than one year after the actual cessation of publication.
- A "**qualified rate**" is basically any rate that measures contemporaneous variations in the cost of newly borrowed funds as long as it is based in the same currency as the rate in the existing contract (including adding or subtracting a specified number of basis points to or from any such rate, or by multiplying any such rate by a specified number).
  - Also included is any rate referencing these rates in its formulation
- "**Associated modification**" includes the modification of any technical, administrative, or operational terms of a contract that is reasonably necessary to adopt or to implement an IBOR replacement modification. In addition, these include any incidental cash payment intended to compensate a counterparty for small valuation differences resulting from a modification to the administrative terms of a contract.
- "**Qualified one-time payment**" is a single cash payment that is intended to compensate the other party or parties for all or part of the basis difference between the discontinued IBOR and the interest rate benchmark to which the qualified rate refers.

Noncovered Modifications

- "Noncovered modifications" — the terms of the contract are modified to change the amount or timing of contractual cash flows and that change is:
  - Intended to induce one or more parties to perform any act necessary to consent to the modification to the contract,
  - Intended to compensate one or more parties for a modification to the contract not related to IBOR replacement,
  - Either a concession granted to a party to the contract because that party is experiencing financial difficulty or a concession secured by a party to the contract to account for the credit deterioration of another party to the contract, or
  - Intended to compensate one or more parties for a change in rights or obligations that are not derived from the contract being modified
- Noncovered modifications are tested under the prior law for a deemed taxable exchange, and not provided the special dispensation under these Final Regulations

Testing Fallback Rates as Covered Modifications

- The final regulations clarify that if an existing contract is modified to adopt IBOR fallbacks, the testing for whether there has been a taxable exchange excepted by the regulations must be done **both** when the fallback mechanics are adopted and when the fallback rate is implemented, if ever
  - If upon implementation of a fallback rate under the contract, that modification is not a "covered modification" under the Final Regulations, taxpayers are left with standards under prior law (*e.g.*, in the case of a debt instrument, the tests under Treas. Reg. 1.1001-3 for determining whether a modification is a "significant modification")
- Each rate in the waterfall must generally be a qualified rate
- Indeterminable rates are not qualified
- Exception for rates with a remote likelihood

Tax Consequences

- For a qualifying modification, *i.e.*, a "covered modification," the regulations provide the result that the modification is not treated as a deemed taxable exchange of the contract under Treas. Reg. §1.1001-1(a)

TAX CONSEQUENCES		
Hedging	**VRDI Rules**	**Other**
For covered modifications on financial instruments like hedges and integrated transactions, a covered modification is not treated as legging out of or terminating the transaction unless the integrated or hedging transaction satisfies the requirements of the applicable regulations within 90 days of the first covered modification of such transaction	Similar to the proposed regulations, relief for a tax advisor's stress: • Fallbacks count as a single rate • An IBOR becoming unavailable treated as a remote contingency	FATCA: a covered modification does not spoil grandfathered status

Open Items

- Character and sourcing – to be the subject of additional regulations
- The final regulations leave room for the addition of more qualified rates and noncovered modifications
- Section 882 interest expense allocation for foreign banks

Effective Dates – Past and Present

- The Final Regulations become effective 60 days after they are published in the Federal Register
- A taxpayer may rely on the Final Regulations before such date, provided that the taxpayer and parties related to the taxpayer apply the regulations consistently
- For IBOR replacement amendments entered into after the Proposed Regulations were issued, but before the date the Final Regulations were issued, taxpayers are permitted to rely on the Proposed Regulations
- As discussed, the Rev. Proc. remains usable guidance

Examples

Example 1: The Old Ways

- Lender and Borrower have an outstanding debt instrument issued in 2015 that pays floating rate interest annually based on three month LIBOR plus a spread
- Lender has the right pursuant to the loan agreement to select a replacement if 3-month LIBOR is discontinued

Example 2: Applying the Proposed v. Final Regulations

- Borrower has no consent right to the rate change
- Lender and Borrower have an outstanding debt instrument issued in 2015 that pays floating rate interest annually based on 3-month LIBOR plus a spread
- The parties modify the instrument to add a SOFR based rate as a fallback on June 1, 2020
- How about if the parties modified on June 1, 2022?

Additional Resources

PANEL 1 ▪ RECENT NAIC DEVELOPMENTS

- NAIC's SAPWG Exposes Proposed Definition of "Bond" for Purposes of SSAPs 26R and 43R
- 2021 US NAIC Prioritizes Climate Risk and Resilience with a Focus on Related Disclosure
- New York Department of Financial Services Issues Proposed Guidance for New York Domestic Insurers on Managing Financial Risks from Climate Change
- Major Change in Capital Treatment for Insurer Investments in "Principal Protected Securities"

PANEL 2 ▪ LIBOR TRANSITION DEVELOPMENTS

- REVERSEinquiries Newsletter, Volume 4, Issue 5
- November 30, 2020 Interagency Statement on LIBOR Transition
- October 20, 2021 Joint Statement
- US IRS Releases Final Regulations Addressing IBOR Transition
- New Rev Proc 2020-44 Provides Limited Relief for Amending Legacy Contracts to Add IBOR Fallbacks

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