GASB guidance for transition from Interbank Offered Rates

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Introduction

A government may be party to a contract or an agreement that pays or receives variable payments that reference an interbank offered rate (IBOR), such as the London Interbank Offered Rate (LIBOR). As a consequence of reference rate reform, LIBOR is anticipated to be discontinued as early as the end of 2021. This has prompted governments to amend or replace contracts that reference LIBOR. In addition, the changes to a reference rate may affect the application of hedge accounting.

Governmental Accounting Standards Board (GASB) Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, as amended, (Statement 53) requires a government to discontinue hedge accounting when it changes any of the critical terms of a hedging derivative, such as its reference rate. In addition, pursuant to GASB Statement No. 87, *Leases*, as amended, (Statement 87) changing the reference rate in a lease agreement requires a government to apply the accounting guidance for lease modifications, including remeasuring lease receivables (liabilities).

To address these and other accounting and financial reporting implications resulting from the replacement of an IBOR, the GASB issued Statement No. 93, *Replacement of Interbank Offered Rates* (Statement 93). Among its provisions, this statement allows exceptions to provisions for hedge accounting termination and lease modifications, which reduce the cost of the accounting and financial reporting ramifications of replacing IBORs and other reference rates. Statement 93 applies to all state and local governments.

Following is high-level summary of some of the key provisions of Statement 93, which should be read in its entirety for a complete understanding of its requirements.

Leases

Statement 93 provides an exception to the guidance for lease modifications in Statement 87 for certain lease agreements that a government amends solely for the purpose of replacing an IBOR as the reference rate. Specifically, as indicated in paragraph 14 of Statement 93, if a lease contract's variable payments are based on an IBOR, and a government amends the lease solely to replace an IBOR with another reference rate (adjusted, as necessary, to equate to the original rate) by either amending the rate or adding or amending fallback language related to the rate, the amendment is not a lease modification for accounting purposes.[1]

Hedging derivative instruments

Exceptions to termination of hedge accounting

Governments commonly issue debt that pays interest based on LIBOR. In addition, a government may hedge the variable cash flows of such debt by entering into an interest rate swap (a hedging derivative) whereby the government pays a fixed rate and receives a variable rate based on LIBOR.

As noted in paragraph A4 of Statement 93, questions have been raised about the application of hedge accounting when a government amends the terms of a hedging derivative, replaces a hedging derivative, or amends a hedged item to replace an IBOR, such as LIBOR, or to add reference rate fallback language. Under Statement 53, if a government terminates a hedging derivative or amends the reference rate of a hedging instrument, it must discontinue hedge accounting, which results in the government recognizing the related deferred outflows (inflows) of resources within investment income immediately.

Statement 93 provides exceptions to the guidance on hedge accounting termination for certain hedging derivatives when a government replaces an IBOR as the reference rate of a hedging derivative's variable payment. A government would continue to apply hedge accounting to a hedging derivative that is determined to be effective as of the last day of the reporting period if the original hedging derivative's reference rate is an IBOR (or an IBOR times a leverage factor or IBOR plus or minus a fixed spread), if all of the following conditions from paragraph 4 of Statement 93 are met[1]:

a. The hedging derivative instrument is amended or replaced to change the reference rate of the hedging derivative instrument's variable payment or to add or change fallback provisions related to the reference rate of the variable payment.

b. The reference rate of the amended or replacement hedging derivative instrument's variable payment essentially equates the reference rate of the original hedging derivative instrument's variable payment by one or both of the following methods:

   i. The replacement rate is multiplied by a coefficient or adjusted by addition or subtraction of a constant; the amount of the coefficient or constant is limited to what is necessary to essentially equate the replacement rate and the original rate.

   ii. An up-front payment is made between the parties; the amount of the payment is limited to what is necessary to essentially equate the replacement rate and the original rate.

c. If the replacement of the reference rate is effectuated by ending the original hedging derivative instrument and entering into a replacement hedging derivative instrument, those transactions occur on the same date.

d. Other terms that affect changes in fair values and cash flows in the original and amended or replacement hedging derivative instruments are identical, except for certain term changes (as specified in paragraph 5 of Statement No. 93) that may be necessary for the replacement of the reference rate.

As noted in paragraph B20 of Statement 93, respondents requested the GASB to provide guidance on a situation where a government has transitioned to the Secured Overnight Financing Rate (SOFR) in two steps. For example, to be proactive, some governments may have amended a hedging derivative from an IBOR to the Effective Federal Funds Rate (EFFR) or the Securities Industry and Financial Markets

[1] Refer to paragraphs B11 through B14 of Statement 93 for further discussion on the replacement of a reference rate. In addition, refer to paragraphs B22 through B25 for discussion on circumstances where a government may make (or receive) an up-front payment to equate the replacement rate and original rate.

Association (SIFMA) swap index. These governments at a later date may switch from EFFR or SIFMA to SOFR. This being the case, the GASB included specific guidance for this two-step transition in paragraph 6 of Statement 93.

Modifications to hedged items

Per paragraph 9 of Statement 93, if a government amends a hedged item to replace an IBOR with another reference rate (adjusted, as necessary, to equate to the original rate) by either amending the reference rate or adding or amending fallback language related to the reference rate, the amendment is not considered a termination event as defined in paragraph 22 of Statement 53.[2]

Probability of expected transactions

Per paragraph 29 of Statement 53, for an expected transaction to qualify as a hedgeable item, the expected transaction should be probable of occurring, supported by observable facts. Paragraph 10 of Statement 93 clarifies that the uncertainty of whether an IBOR will continue to be available does not, in and of itself, impact the assessment of whether the hedged transaction's occurrence is expected to be probable. That is, while a government still needs to assess whether a hedged transaction is probable of occurring, the fact that the transaction's variable payments may at some point in time no longer be based on IBOR does not in and of itself mean the hedged transaction is no longer probable of occurring.

Appropriate benchmark interest rates

For the qualitative evaluation of the effectiveness of an interest rate swap, paragraph 11 of Statement 93 does the following:

a. Removes LIBOR as an appropriate benchmark interest rate when hedging the interest rate risk of taxable debt

b. Identifies an interest rate on direct U.S. Treasury obligations, the EFFR, and the SOFR as appropriate benchmark interest rates when hedging the interest rate risk of taxable debt

Effective date and transition

The removal of the London Interbank Offered Rate as an appropriate benchmark interest rate is effective for reporting periods ending after December 31, 2021. All other requirements are effective for reporting periods beginning after June 15, 2020, except for the requirements related to lease modifications, which are effective for reporting periods beginning after June 15, 2021. Earlier application of Statement 93 is encouraged.

The following transition requirements are provided in paragraph 16 of Statement 93:

> Changes adopted to conform to Statement No. 93 should be applied retroactively by restating financial statements, if practicable, for all prior periods presented. If restatement for prior periods is not practicable, the cumulative effect, if any, of applying the Statement should be reported as a restatement of beginning net position (or fund net position) for the earliest period restated. In the first period that Statement No. 93 is applied, the notes to financial statements should disclose (a) the nature of the restatement and its effect; and (b) the reason for not restating prior periods.

The following insight related to the meaning of *if practicable* is provided in paragraph B61 of Statement 93:

> The phrase *if practicable* has been used in other GASB standards in a similar context as used in this Statement with respect to transition provisions that require restating the financial statements for all

[2] Refer to paragraphs B11 through B14 of Statement 93 for further discussion on the replacement of a reference rate. In addition, refer to paragraphs B22 through B25 for discussion on circumstances where a government may make (or receive) an up-front payment to equate the replacement rate and original rate.

> prior periods presented. The Board believes that reasonable efforts should be employed before a government determines that restatement of all prior periods presented is not practicable. In other words, *inconvenient* should not be considered equivalent to *not practicable.*

An example of a circumstance that would warrant restatement is a government entity that amends or replaces a hedging derivative instrument in a reporting period prior to the reporting period in which it adopts Statement 93, and as a consequence, is required to discontinue hedge accounting. Upon adopting Statement 93, the entity would need to restate the prior period(s) to reflect the continuous application of hedge accounting if the requirements to continue hedge accounting are met.

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