RICARDO LARA
CALIFORNIA INSURANCE COMMISSIONER

BULLETIN 2020-9

TO: **All Domestic Insurers and Other Interested Parties**

DATE: **July 30, 2020**

RE: **Clarification of California Law on Derivatives**

The purpose of this bulletin is to clarify whether certain basis swaps will be deemed a permissible derivative investment.

The London Interbank Offered Rate (LIBOR) is a benchmark interest rate based on average rates for short-term interbank unsecured loans which has been used as the benchmark for evaluating derivative transactions. LIBOR is expected to be replaced as the interbank borrowing rate after 2021 and another mechanism – the Secured Overnight Financing Rate (SOFR) was identified as its replacement. By transitioning from LIBOR to SOFR, U.S. central clearing counterparties (CCPs) will shift their discounting rate from the Effective Federal Funds Rate (EFFR) to SOFR using a one-time special valuation cycle occurring on October 16, 2020. The CCPs will revalue existing cleared swaps and issue basis swaps on a mandatory basis to all parties that clear swaps on the CCPs to restore a counterparty's original risk profile.

A derivative instrument is defined in California Insurance Code § 1211(a)(5). The statute notes that a derivative instrument "includes all investment instruments or contracts that derive all or almost all of their value from the underlying market, index, or financial instruments," and that the term includes swaps. Thus, in the context of a clearinghouse's shift in discounting from the EFFR to the SOFR (CCP Cutover), the Commissioner makes clear that any basis swap (or group) incurred by a domestic insurer in connection with a CCP cutover meets the definition of a derivative instrument in the California Insurance Code, and shall be deemed a permissible derivative investment for up to one year past the date of the CCP Cutover.