Are you ready for a world beyond LIBOR?

Reporting Update

27 June 2019, 19RU-010

Highlights

- Background to LIBOR replacement
- Key considerations
- How KPMG can assist

Background

LIBOR benchmark replacement

From 2022, there will be a transitioning from the use of London Interbank Offered Rate ("LIBOR") as the predominant benchmark interest rate to other alternative rates for five currencies. LIBOR for U.S. Dollar, Pound Sterling, Euro, Japanese Yen and Swiss Franc will be replaced by risk free rates (RFRs).

There is significant uncertainty about how the transition to RFRs will be implemented. There will be no single global successor to LIBOR. Instead it is currently expected that for:

- USD, LIBOR will be replaced by the US Secured Overnight Financing Rate (SOFR)
- GBP by the Reformed Sterling Overnight Index Average (SONIA)
- Euro by Short-Terms Rate (ESTER)
- JPY by Tokyo Overnight Average rate (TONA) and
- CHF by Swiss Average Rate Overnight (SARON).

Some of these new rates are already available in the market, however the timing and precise nature of the change is uncertain.

Although the Australian (BBSW) and New Zealand (BKBM) benchmarks are not currently affected, **there is an increasing awareness of alternative rate for Australia. For example, the Australian Overnight Indexed Average (AONIA) was used as the benchmark rate in a recent bond issue.**

Entities with exposures to LIBOR are encouraged to start planning and preparing how they may be impacted by the phasing out of LIBOR and transitioning to new benchmark rates to ensure the change has minimal financial and operational impact.

"Transitioning to a world beyond LIBOR represents a significant challenge to organisations, and the impact is not limited to financial institutions. In order to ensure a smooth transition, entities should engage early and ensure they are identifying all impacted contracts to allow time for contractual renegotiations".

Patricia Stebbens
Partner, Department of Professional Practice

Key considerations

Involvement of legal, finance and tax, treasury and business operations are likely in a LIBOR transition project. A project will include the following considerations:

Identification of exposures

Whilst it may be relatively straight forward for some entities to identify funding arrangements, including financing from financial institutions such as banks, or the debt capital markets, or intercompany funding and derivatives that are referenced to LIBOR, entities should also consider other contracts that may be impacted such as lease contracts or procurement or sales contracts. For example, some supply contracts in the extractive industry or energy market contain penalties linked to LIBOR. Management may need to implement a process to ensure that all exposures to LIBOR are identified and managed. Contracts need to be analysed to determine the appropriate strategy for achieving contractual changes (in advance of the changes being applied, rather than maturity of the existing contractual arrangements).

Entities should also ensure any new contracts entered into that are expected to extend beyond 2021 have provisions in the contract that will enable them to have a seamless transition to the new benchmark rates.

Contract amendments

For all exposures identified, entities will need to commence negotiations with the counterparty to determine the new appropriate interest rate to be used in place of LIBOR. This may involve significant costs and added complexities as different jurisdictions are moving to different RFRs.

Treasury Systems

The software in many treasury systems relies on LIBOR information for valuations and other processes. These entities will need to establish the appropriate strategy for uploading the changes onto the treasury systems in a timely manner.

These treasury valuation systems changes cannot wait until 2021. If entities have existing instruments that extend beyond 2021, systems will need to be reviewed to ensure that they could be updated with new discount rates in order to appropriately value the financial instruments (and potentially any amended cash flows on them).

This may be a challenging process as insufficient liquidity in RFRs may cause challenges in the constructions of the interest rate curves.

Accounting implications

Changing interest rates are likely to have significant accounting consequences including:

- Discount rates – impact on impairment testing, fair value valuations and lease accounting. LIBOR is often used as the underlying discount rate in a number of different valuations including impairment testing for non-financial assets under AASB 136 *Impairment of Assets*, fair value estimations under AASB 13 *Fair Value Measurement* and lease calculations under AASB 16 *Leases*.
- Hedge accounting
  Changes in both hedging instruments and underlying hedged items will have potential hedging and hedge accounting impacts. The IASB is currently

considering whether relief should be provided to simplify the impacts of transitioning from LIBOR to a new benchmark. Refer to our web article for further information.

- Debt and leases modifications
  Any change in the interest rate of a loan arrangement would need to be assessed to determine whether it is classified as a debt modification. A debt modification may result in an immediate P&L impact. Some payments in lease arrangements are indexed to LIBOR. Entities should consider the impact of a change in the index on lease accounting.

- Disclosures
  Consideration should be given by entities with exposures to LIBOR as to whether it is necessary to provide disclosures in their financial statements about the potential future impact including any profit and loss impact. AASB 7 *financial Instruments: Disclosures* discuss the need to provide disclosures around the objectives, polices and processes for managing risks. Other considerations include disclosures of significant estimates and judgements as required by AASB 101 *Presentation of Financial Statements*. For example, LIBOR might be factored into valuation models as discussed above.

Taxation

Entities should consider whether there are any potential taxation impacts, such as transfer pricing due to the potential repricing of any intra-group loans.

Other business impacts

Entities should also consider other broader business consequences of LIBOR replacement such as value transfers between different stakeholders. For example, in the fund industry where values are attributed based on fair value as the inputs to the valuation methodology change as a result of the phasing out of LIBOR.

How can KPMG support you?

Impact Assessment	Transition Planning	Stakeholder Management	Transition Implementation
• Analysing the entity-specific impacts based on the implications for following areas: ➢ Accounting and Tax ➢ Regulatory and Legal ➢ Valuation and Curve construction ➢ Risk Management ➢ Operation and IT-Infrastructure ➢ Treasury and Liquidity. • Identifying affected products, loan agreements and contracts – locally and internationally (in particular to include foreign subsidiaries)	• Designing a detailed planning based on below: ➢ Different identified contracts affected ➢ Implications for different functions. • Establishing entity-wide governance structure and status reporting cadence to manage the plan and status for transition across different areas, business lines and geographical locations of your entity	• Managing and participating in your discussions and contract renegotiations with various external parties, including: ➢ Financial institutions, e.g. your banks, other financiers and derivative dealers ➢ System providers and vendors ➢ Regulators and authorities.	• Providing support of the implementation across relevant business lines and functions • Performing go-live readiness assessment and quality assurance on contract amendments

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