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Negative interest rates - financing arrangements

Reporting Update

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Highlights

- Australia now has the potential to see negative interest rates for the first time
- Negative interest rates may trigger clauses relating to interest rate floors in loans
- Interest rate floors in loans may not be replicated in hedging instruments
- In certain circumstances, this may give rise to hedge ineffectiveness and outcomes which are inconsistent with management's risk management strategy

Background

Negative intra-day forward interest rates

On 3 November 2020, the Reserve Bank of Australia (RBA) reduced the official cash rate, the 3-year Australian Government bond yield target rate and the Term Funding Facility rate from 0.25% to an historic low of 0.10%. In the short-term markets, the 3-month Bank Bill Swap Rate (BBSW or BBSY), continued its downward trend and traded at 0.02%. Although Australia has never experienced negative interest rates, it is now a real possibility and there have already been instances (intra-day) where the interest rate forward curve has dipped into negative territory.

Globally, several other countries have had negative interest rates for some time, however, it is the first time that Australian interest rates have fallen this low. New Zealand is also experiencing very low interest rates for the first time, and similarly the BKBM (the New Zealand benchmark) forward interest rate curve has slipped into negative territory in recent times.

Potential impacts on financing arrangements

Impact of negative interest rates on loan arrangements

Theoretically, when the benchmark rate becomes negative, lenders will be paying, rather than receiving, BBSW to their customers on loan arrangements. In practice, given the margins on borrowings, it is not expected that the overall interest rate will drop below zero.

However, to protect lenders' exposure to negative interest rates, it is now not uncommon for lenders to insert a minimum or zero interest floor clause in loan agreements. For example, a floating rate loan priced at BBSW3m plus a 2% margin may now have a clause that there is an interest rate floor of 0% on the BBSW3m component. When BBSW becomes negative, the borrower would only pay the 2% margin to the lender with the BBSW component fixed at zero.

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What is the issue?

Impact on risk management strategy

In order to manage the floating interest rate exposures arising from loans, entities commonly enter into interest rate derivatives to mitigate their risks and designate these derivatives as cash flow hedges for accounting purposes. For cash flow hedge purposes, entities hedge the variability due to the BBSW component on the loan and not the margin.

However, unlike the more recent loan agreements which have included interest rate floors on the benchmark rates, interest rate swaps typically do not contain any floors. As a result, there will be no corresponding offsetting impact from the loan in a negative interest rate environment.

For example, an entity has a loan paying BBSW +3% with a floor of zero on the BBSW component. It enters into an interest rate swap where it agrees to pay 4% and receive BBSW. Under this strategy, when interest rates are positive, there is an economic relationship between the loan and the interest rate swap which results in the entity fixing its interest rate at 7% (3% margin plus 4% on the swap). However, in a negative interest rate environment, it will result in paying more than 7%. For example, if BBSW is negative 1%, the entity will pay 5% under the swap, and 3% on the loan, a total of 8%.

Accordingly, where a loan (**hedged item**) contains a floor for the benchmark interest rate and it is hedged with an interest rate swap (**hedging instrument**) that does not contain a similar floor on the benchmark rates, questions such as whether the interest rate swaps are still appropriate for the purposes of achieving the documented risk management strategy and the impact on financial reporting will arise.

What are the potential accounting implications?[1]

Financial reporting implications

A number of financial reporting implications could arise from a negative interest rate environment depending on the entity's risk management strategy. For example, where the interest rate exposure is hedged, all or part of the change in fair value of the derivatives may be recognised in the Income Statement as hedge ineffectiveness. In certain scenarios, for example, where it is expected that the benchmark rates will remain below the floor for an extended period, the relationship could fail hedge accounting. In addition, key financial ratios such as interest cover ratios will be impacted.

[1] Negative interest rates may also have broader accounting implications such as:

- Capability of valuation systems used to measure assets and liabilities; and
- Impact on discount rates applicable across various other accounting standards (for example, impairment, leases, provisions, employee benefits).

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Assess readiness and potential impacts

Actions to take

Businesses should:

- **Identify** whether there are interest rate floor clauses in loan agreements and understand the application of those interest rate floor clauses (e.g. whether floor is applied on BBSW or BBSW plus margin)
- **Determine** whether derivatives such as interest rate swaps used to hedge these loans have a similar interest rate floor
- **Review** the set-up of loans in accounting systems to ensure the change in cash flows of the loans incorporates the impact of the interest rate floor
- **Assess** whether any impacted hedge relationships continue to meet the criteria for hedge accounting, and
- **Quantify** any hedge ineffectiveness required to be recorded in the Income Statement.

Key Contacts

Patricia Stebbens
Partner
pstebbens@kpmg.com.au
(03) 9288 6261

Kevin Yeo
Director, CFO Advisory
kevinyeo@kpmg.com.au
(03) 9288 5316

Justin Turnbull
Associate Director, CFO Advisory
jturnbull1@kpmg.com.au
+61 2 9455 9568

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