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IBOR Reform

The impacts of interest rate benchmark reform on financial reporting

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The future of the London Interbank Offer Rate (LIBOR[1]) has become highly uncertain since the UK's Financial Conduct Authority (FCA) announced in 2017 that it would not compel or persuade panel banks to make LIBOR submissions after 2021. On 5 March 2021, the UK FCA announced the cessation of most LIBOR settings by the end of 2021 and the cessation of the remaining (USD) LIBOR settings by mid-2023. The publication of LIBOR is not guaranteed beyond 2021 and public authorities in many jurisdictions are undertaking steps to reform interbank offered rates (IBORs) and transition them to alternative risk free rates (RFRs).

LIBOR is currently used within a broad range of financial instruments, so companies can expect the rates transition to significantly impact a number of their functions and businesses. Organizations that don't act now may face increasing costs and resource needs to manage the transition.

While the efforts to prepare for the transition away from LIBOR will be significant, operational readiness may be most demanding of all. KPMG professionals are assisting with the assessment of how wide and deep the impact may be and they are guiding numerous companies through the planning and implementation of necessary changes. The number of operational factors that must be considered grows quickly when impacts on products, systems and legal departments are entered into the mix. Structural differences between LIBOR and its proposed replacements make operational uncertainty unavoidable. These challenges are further exacerbated by looming unknowns in market conventions, market structure and legal certainty – not to mention the rapidly approaching LIBOR end-date.

The purpose of this article is to discuss the potential impact of the IBOR transition which, depending on the circumstances of the company, has consequences for many critical aspects of organisations, touching on financing transactions, contracts, operations, systems, models, processes, and accounting.

Global challenges

IBORs currently underpin a huge range of financial products and valuations, from loans and mortgages through securitisations and to derivatives across multiple jurisdictions. They are used in determining many types of pension, insurance, leasing agreements and are embedded in a wide range of finance processes such as remuneration plans and budgeting tools. The tax impact of all these items will also need to be considered.

The transition will, therefore, be felt far and wide. The challenge will be particularly acute for central counterparties, exchanges, banks, insurers, and asset managers, but the ripple effects will also be felt by corporations and consumers as the transition impacts, for example, the valuation and accounting for derivatives, corporate bonds, and business and consumer loans. The impact of IBOR reform need to be considered under the following headings.

[1] LIBOR is quoted for five currencies (USD, GBP, EUR, CHF and JPY)

Accounting & Tax

- Impacts on fair value calculations
- Impacts on hedge accounting
- Changes in the basis of determining the contractual cash flows
- Impacts on financial statement disclosures
- Potential tax impacts

Regulatory & Legal

- Additional costs incurred in relation to contracts' amendments
- Difference in risk-free rates' (RFRs') calculations across jurisdictions
- Requirements for the inclusion of suitable fallback provision in agreements

Valuation & Curve Construction

- Impacts on pricing and valuation of financial instruments (e.g. appropriate discount rates)
- Challenges in curve construction
- Adjustments needed to the existing curve framework
- Modification of risk-free elements across the entity

Risk management & liquidity

- Operational risks resulting from differences between existing and new contracts and their impact on processes such as pricing, valuations, and risk modelling
- New hedging and insurance plan programs needed
- Potential conduct risks arising in back book transition
- Initial liquidity risks in the RFRs' markets

Operation & IT infrastructure

- Documentation, implementation and administration of the transition
- Updates to processes and systems
- Assessment on where the risk might be

Specific accounting challenges and impacts for corporate treasurers

In order to address issues that might affect financial reporting during the reform of an interest rate benchmark, the IASB made certain amendments to accounting standards (the Amendments[2]) . The main objectives of these Amendments were to ensure that the move to the new RFR benchmark rates was simplified by providing reliefs (i) from the usual modification accounting requirements that apply when financial instrument contracts are revised and (ii) from hedge accounting cessation that might otherwise have occurred due to changes in the hedged risk to the new RFRs.

Accounting for the modification of financial instruments

The replacement or reform of an interest rate benchmark is likely to change the basis for determining the contractual cash flows of, for example, a variable rate sterling loan liability with interest payments linked to GBP LIBOR that is carried at amortised cost. Under the normal IFRS 9 accounting rules, this requires a company to assess whether changing the basis for determining contractual cash flows is so substantial that it results in the derecognition of the loan with potentially a significant gain or loss arising. Even if the change results in no derecognition, an immediate re-measurement gain or loss might still arise.

The IASB amended IFRS 9 to introduce a practical expedient that if a change results directly from IBOR reform and occurs on an 'economically equivalent basis', in these cases, changes will be accounted for prospectively by updating the effective interest rate.

The practical expedient is conditional on the new contractual cash flows being 'economically equivalent' to the previous ones. If the revised terms are not considered to be 'economically equivalent' the usual more onerous loan modification requirements apply. In practice, the determination of whether revisions are 'economically equivalent' can be complex, with care needed in making this determination.

Any other loan contract revisions that go beyond those required by IBOR reform need to be dealt with using the usual modification requirements in IFRS 9 (including assessing whether the change results in derecognition of the loan).

It is worth noting that all loan contracts carried at amortised cost must be analysed for embedded derivatives upon issuance and modification, especially if there are changes that do not qualify as being economically equivalent to the old terms or there are additional changes not required by IBOR reform.

Similar practical expedients will apply under IAS 39 Financial Instruments: Recognition and Measurement for insurers that have not as yet transitioned to IFRS 9 as well as under IFRS 16 Leases for lessees when accounting for lease modifications required by IBOR reform.

Hedge accounting

When a company applies the hedge accounting requirements of IFRS 9 or IAS 39, changes to the basis for determining the contractual cash flows of a financial instrument designated in a hedging relationship would affect its designation. The changes would generally result in the discontinuation of hedge accounting.

However, **the IASB has introduced reliefs from specific requirements in order for the company to continue hedge accounting in circumstances when changes to hedged items and hedging instruments arise as a result of changes required by the reform.**

In particular, the company can and should amend the documentation of the hedging relationship including the hedged risk, the description of the hedged item and hedging instrument and the effectiveness assessment methodology, as soon as uncertainty ends.

Companies must be aware of potential mismatches between hedged items and hedging instruments due to troublesome fallback provisions in loan agreements that may make the continuation of hedge accounting impossible unless the terms are renegotiated. For example, some loan agreements may say that if LIBOR is no longer available then the contracted rate is the last published LIBOR rate, this would then make the contract a fixed rate contract and not a floating rate contract.

Additional reliefs have been provided as follows:

- Amounts accumulated in the cash flow hedge reserve are deemed to be based on the alternative benchmark rate.
- There is a relief from the 'separately identifiable' requirement if a company has a reasonable expectation that the alternative benchmark rate will meet the requirement within 24 months from designation.
- There is the ability to allocate groups of items originally designated as hedged items to subgroups within the hedging relationship based on the benchmark rate being hedged.
- A company may reset to zero the cumulative fair value changes of the hedged item and hedging instrument in the retrospective effectiveness assessment of IAS 39 when ceasing to apply the Phase 1 relief (which occurs when uncertainty ends).

[2]Similar amendments to FRS 102 have been made by the FRC

Disclosures

A company is required to disclose additional information in its financial statements so that investors can better understand **the reform's effects on the company's financial instruments and its risk management strategy.**

Disclosures will need to include:

- the nature and extent of risks to which the company is exposed arising from financial instruments that are subject to IBOR reform, and how the company manages those risks; and
- the company's progress in completing the transition to alternative benchmark rates, and how the entity is managing that transition.

Quantitative information is expected about non-derivative financial assets, non-derivative financial liabilities, and derivatives, each shown separately, that have yet to transition to an alternative benchmark rate as at the end of the reporting period.

How can KPMG Help?

While the timing and transition to RFRs are still uncertain, there is much that corporates can do to prepare. The key is to develop a transition plan and take measures to minimize the transition's financial reporting and operational impact on the business.

KPMG's highly experienced and multidisciplinary team leverages expertise across the firm to provide clients with subject matter experts who can assess and analyse complex risks and provide meaningful industry focused insights.

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