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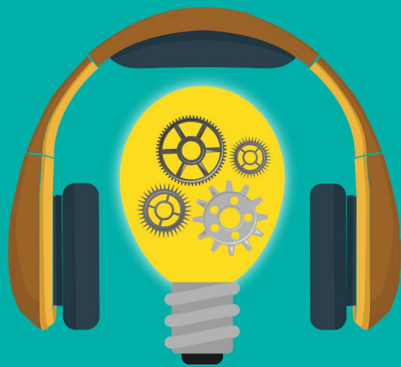

KPMG's podcast series on IFRS and financial reporting

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EPISODE TRANSCRIPT

Calling all companies – How will you be impacted by interest rate reforms?

Speakers

- Colin Martin (Host)
- May Tiem Gillen
- Sarah Kindzerske

Colin

Hello, and welcome to this brief session on the proposed reform of interest rate benchmarks – or IBORs.

My name is **Colin Martin**, a partner with over 25 years of financial sector accounting experience. Over the next 10 minutes we'll explain why the reforms have been proposed, what they are and why they are so important for all companies globally, and not just financial services.

I'm joined today by two colleagues who share vast experience in the banking and financial instruments arena – **May Tiem Gillen** and **Sarah Kindzerske**.

May Tiem – before we get into the detail, could you help our listeners to understand why these changes – and the resulting transition away from IBOR to new benchmark rates – are such a big deal?

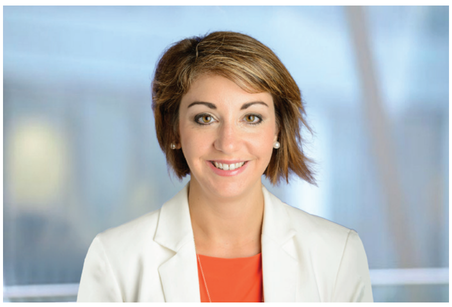
May Tiem Gillen
Director
Banking Accounting Advisory Services
KPMG in the UK

May Tiem

Absolutely, Colin – we're talking here about interest rate benchmarks that currently underpin a huge range of financial products and valuations across multiple jurisdictions. In fact, the last estimate I saw was that $420 trillion dollars of contracts are indexed to an interbank rate like LIBOR.

Some of you may be more familiar with 'LIBOR' but throughout this we'll use the term 'IBOR' to refer to any interbank-offered interest rate – such as sterling-LIBOR, USD-LIBOR, Euribor…

In all of these jurisdictions, IBORs are typically used in treasury, funding and leasing arrangements. They are embedded in a range of risk and finance processes. *And more importantly, they are all expected to cease to exist by 2022…*



Sarah Kindzerske
Senior Manager
International Standards Group

Sarah

That's right, May Tiem, and I'd just add that the changes could impact the interest rates that companies and banks use not only to calculate the interest due on a loan, but also the interest rate that a company or bank uses to derive fair values on all types of financial instruments.

That's why this is significant for *all* companies and not just for banks.

Colin

Thanks, both.

As you can see, there's a big change due… We don't have all the detail on how it's going to pan out – such as exact implementation dates…

But make no mistake, whatever the exact timings are going to be, these changes look inevitable… So a key question for any company has to be, 'What can we do today to make sure we have no regrets tomorrow?'

But before we get to that – Sarah, could I ask you to outline the story behind the reforms, please?

Sarah

Well, as May Tiem said, IBOR is being replaced: In the UK. In the US. In Japan. In Switzerland. Everywhere throughout the world.

Which means that a 'quoted' benchmark rate will no longer be available. It will be replaced with an actual transaction rate that is demonstrable and verifiable – in other words, it will be a historical rate, not forward-looking. The term that's being widely used right now for this new benchmark is 'risk-free rate' or 'RFR'.

Which is why – as I mentioned earlier – these reforms could impact interest rates that companies and banks use not only to calculate the interest due on a loan, but also the interest rate that a company or bank uses to derive its fair values on all types of financial instruments.

Colin

Thanks, Sarah.

And, of course, the trigger for these changes goes back a long way at least until the financial crisis when the attempted manipulation of the benchmark rates first came to prominence and resulted in a decline in market confidence over their robustness and reliability.

After that, the G20 countries asked the Financial Stability Board to undertake a fundamental review of the major interest rate benchmarks.

May Tiem

That's right, Colin.

Working groups were set up for each of the five IBOR currencies – the US dollar, UK pound sterling, Japanese yen, the Swiss franc and the euro – and each working group is responsible for developing alternatives to IBOR within their home jurisdictions.

A replacement rate has now been determined in most jurisdictions, and so begins the process of actually replacing the old IBOR benchmark rate with the new risk-free rate.

Colin

Well, this is obviously going to have wide-ranging effects on companies – both from an operational perspective and an accounting perspective.

Sarah, the International Accounting Standards Board (the Board) has recently released its proposals for how to address some of the accounting issues associated with IBOR reform. Can you talk us through them?

Sarah

Yes, of course. In May, the Board issued an exposure draft to address some of its stakeholder concerns. The ED proposes relief, but the relief is just for the period up until uncertainty ceases with regards to the timing and amount of cash flows or fair value from replacing the existing IBOR with an alternative risk-free rate.

The proposals focus only on providing targeted relief for certain forward-looking requirements related to hedge accounting – both under IAS 39 and IFRS 9.

Specifically, the effect of the proposed targeted relief means that a hedging relationship does not need to be discontinued, or amounts reclassified from a hedging reserve, just because of uncertainty over the timing and amount of future cash flows.

Colin

But the financial reporting impact of IBOR reform extends beyond hedge accounting, doesn't it? May Tiem, you mentioned impacts for loan valuations and lease liabilities?

May Tiem

That's right, Colin. What's happening here is definitely not just a niche concern for banks.

As I said earlier, IBORs currently underpin a huge range of financial products and valuations across multiple jurisdictions – they are typically used in treasury, funding and leasing arrangements.

And they're embedded in risk management such as risk and valuation calculations, treasury management, funds transfer pricing and finance processes.

Colin

So, in your experience, have *all* companies engaged with this issue?

May Tiem

Well… Banks have certainly engaged and we're getting a lot of questions from them, but companies seem to be waiting for the banks to approach them.

I would really encourage companies to approach their banks – amending contractual terms for floating-rate loans, for example, may not be straightforward and it is better to start sooner rather than later.

Colin

Okay – so companies should approach their bank. What about other actions that you'd recommend that companies take?

May Tiem

These IBOR reforms will affect many areas of your business, such as risk, systems, data and processes.

So I would certainly recommend performing an initial impact assessment.

Some larger corporates have already started their impact assessments – for example, setting up working groups to identify exposures to IBORs and the broader business impacts across the organisation.

Colin

It seems pretty clear that the implications are wide-ranging and they're still emerging as banks and corporates start to grapple with some of the potential issues.

Sarah, I'd like to come back to the IASB's proposals for a minute. You said that the IASB's current proposals generally deal with only the financial reporting considerations for the period *up until* the benchmark rate is replaced.

Can you talk us through how the Board is planning to consider the *other* reporting implications?

Sarah

Sure. The Board is considering the related accounting points in two stages:

– the first stage is this pre-replacement stage, which is the period up until IBOR is replaced; and

– the Board also indicated that there will be a phase 2, which will assess the potential accounting implications of reform when it occurs – but it hasn't committed yet as to when it will take any further action.

Colin

Well, that sounds like an interesting approach. Do you have any insight on how the Board's proposed two-phase plan has been received in the market place?

Sarah

I think it is widely accepted that relief will be necessary at some point in the future.

But there are still many questions around a whole population of potential accounting implications.

For example, in a longer-term floating-rate loan, how will replacing the IBOR rate with an alternative risk-free rate be accounted for? And will companies use this as an opportunity to amend other terms of the loan? These types of changes could trigger a company to assess whether the instrument has been modified, which could possibly lead to derecognising the instrument or applying the modification requirements of IFRS 9.

There are also more practical issues, such as 'will updating my hedge documentation result in de-designation or re-designation of a hedge?'

So we encourage the Board to act swiftly for the second phase of the project, given the timeline of replacing IBORs.

Colin

Okay, on the subject of that timeline, my understanding is that the market expects reforms to be in place by 2022 for all of the major currencies. May Tiem – Can you give our listeners an idea of how the preparations are going?

May Tiem

Well – it varies according to local jurisdictions, and that is part of the complexity. So, for example, we're expecting the reforms to take effect in the UK from 2021. However, in the US they're expected to be effective from 2022…

Colin

Interesting – thank you. Well, I think we have covered quite a lot in a short space of time there so it would be great if you could give a quick recap and perhaps share with us what you think the next steps are for all entities with IBOR exposures.

Sarah

I think it's fair to say that these IBOR reforms are a big deal.

Hedge accounting is a small sliver of the scale of the impact and corporates and banks alike need to start thinking about how IBOR reform impacts them.

First, you need to get the ball rolling on preparing a smooth transition to risk-free rates so your absolute priority has to be setting up an organisation-wide, cross-functional risk-free rate task force.

Second, with this structure in place, you need to start thinking about initial impacts and ways to minimise potential risks.

May Tiem

I definitely agree with Sarah and would stress that even though the road ahead is unclear, you still need to get started. Whatever the timing of IBOR reform for your jurisdiction, you need to start taking a 'no-regrets' approach that will support your transition.

As a third step, I'd say you need to identify your exposures. Catalogue your inventory of financial instruments, assets and liabilities that use or rely on a benchmark – either directly or by proxy. Start analysing the legal language and open the relevant conversations now.

Sarah

That's right... Step four then has to be embedding the right governance and awareness to provide oversight of any resulting changes – to policies, systems, processes and controls. You need to make sure that your employees are up to speed on the implications of the transition – every step of the way.

And finally, as with all change, think about how you might communicate the potential impacts of IBOR reform to your stakeholders and investors.

Colin

Thank you both.

It's fair to say, then, there are lots of challenges ahead.

You'll be able to find out more about some of the activities you can undertake to prepare for the transition to RFRs in the **summary PDF** that's available on the web page for this podcast.

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But for now, thank you all very much for taking the time to listen to this edition of *IFRS Today*.