

IBOR reform Phase 2

Reporting Update

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All IBOR benchmarks will be replaced with new alternative benchmarks (ABR)

Highlights

- What is the issue?
- Recent IBOR developments
- Financial reporting implications of IBOR reform
- Practical examples

What is the issue?

A global reform of major interbank offered rate (IBOR) benchmarks is currently underway. The reform involves the replacement of commonly used interest rate benchmarks with **alternative benchmark rates** (ABR). The replacement of IBOR benchmarks could have significant implications for financial instruments accounting, especially for organisations that have:

- **Borrowings, receivables** or **leases** referencing an IBOR benchmark,
- **Derivatives** referencing IBOR benchmarks, and/or
- Applied **hedge accounting** in accordance with either AASB 9 *Financial Instruments* (AASB 9) or AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139).

In response, the International Accounting Standards Board (IASB) published amendments to existing accounting standards in two phases.

Phase 1 of the amendments addresses the potential impacts on hedge accounting arising from uncertainty during the periods leading up to the replacement of IBOR.

Phase 2 focuses on financial reporting issues that might arise when IBOR benchmarks are replaced in contracts. Further detail about the IBOR reform project can be found in our [IBOR reform phase 1 amendments Reporting Update](#).

“The end of IBOR is in sight and organisations affected will be required to apply the relief granted by the IASB in their Phase 2 amendments. This relief allows organisations to change interest rates and amend hedge designations and documentation without significant disruption. However, the accounting can get complicated where additional changes to borrowings and derivatives are made over and above those required by IBOR reform. If this is the case for your organisation, it is recommended you consult with your advisor to assist in working through the accounting impacts”.

Patricia Stebbens
Partner, Department of Professional Practice

All IBOR benchmarks are expected to cease by July 2023 with many ending in January 2022

The accounting impacts will be minimal where an organisation transitions from an IBOR benchmark to a new ABR on terms that are considered economically equivalent

Recent IBOR developments

Following an announcement by the UK's Financial Conduct Authority (FCA), LIBOR for GBP, EUR, CHF, JPY, and some less commonly used USD LIBOR tenors¹ will no longer be available from the end of 2021. The remaining USD LIBOR rates will cease after 30 June 2023.

In October 2020, the International Swaps and Derivatives Association (ISDA) published amendments to ISDA's standard definitions for interest rate derivatives to incorporate fallback rates for contracts linked to certain IBORs. These fallback rates are intended to replace prescribed IBOR benchmarks once those benchmarks are no longer available. For example, upon cessation of the GBP LIBOR benchmark the reference rate for impacted derivative contracts will be SONIA plus a fixed spread.

All new derivatives transacted from 25 January 2021 that reference the ISDA definitions will include the fallback provisions. For derivatives entered before 25 January 2021 the fallback rates will only apply if the counterparties agree to adopt the amended ISDA definitions.

Whilst contractually the fixed spread applicable to derivatives may not apply to lending agreements, it is expected that they will serve as a useful reference point in bilateral negotiations between borrowers and lenders when renegotiating the reference rate in floating rate loans.

Financial reporting implications of IBOR reform

As a result of the IBOR Reform Phase 2 amendments, the financial reporting impacts are expected to be minimal where loan agreements, leases and derivatives are amended only to effect changes required by IBOR reform².

Where the new basis for determining the contractual cash flows of the financial instrument or lease is **economically equivalent** to the previous basis (i.e., the basis immediately preceding the change) an organisation must:

- Treat changes to interest rates on loans and borrowings on a prospective basis by revising the effective interest rate,
- Remeasure any affected lease liability using the guidance for a change in an index or a rate, and
- If hedge accounting is applied, update the hedge documentation (including the designated hedged risk, the identified hedging instrument and associated hypothetical derivative) to ensure that hedge accounting can continue.

Complexity arises where changes in addition to those required by IBOR reform are made to the terms and conditions of the arrangement. In these scenarios the financial reporting impacts may be more significant, for example borrowings may need to be remeasured or hedge relationships discontinued, potentially resulting in an impact on profit or loss. The guidance on navigating through the impacts of these additional changes is complex, therefore, where this situation arises, we recommend consultation with your advisor.

¹ Namely the 1-week and 2-month US dollar LIBOR settings

² There are additional disclosures, refer to [KPMG Example Public Illustrative Disclosures](#)

The accounting complexity increases significantly when changes are made over and above those required to effect IBOR reform

Practical examples - index of questions

Measurement of loans and borrowings

- A.1** Will the transition to an ABR give rise to an immediate P&L impact?
- A.2** When is a change considered to be “economically equivalent” and how should this be documented?
- A.3** Could an IBOR benchmark be replaced with an ABR without any change to the fixed margin?
- A.4** Can the phase 2 amendments be applied where an IBOR benchmark is replaced by a fixed rate?

Changes in addition to those required by IBOR reform

- B.1** Where the interest rate is changed to the current market rate, can this be considered economically equivalent?
- B.2** What are the recognition and measurement implications where a change is not considered to be economically equivalent?

Hedge accounting

- C.1** What is an organisation required to do when they have hedge accounting relationships (either cash flow or fair value)?
- C.2** Can hedge accounting continue if changes over and above those required by IBOR reform are made to the hedged item or hedging instrument?
- C.3** What are the accounting implications if changes made to the borrowing and CCIRS, required due to IBOR reform, occur at different points in time?
- C.4** How should the hypothetical derivative be defined if the hedged item and hedging instrument are amended at different times?
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Leases

- D.1** What are the implications for a lessee if there is a change in lease payments due to IBOR Reform?

Practical examples - question and answer

Measurement of loans and borrowings

Scenario A

Consider the following fact pattern:

Company X has a borrowing of GBP 1 million with 5 years remaining. The interest rate on the loan is based on 6-month GBP LIBOR plus a fixed margin of 4%.

As a result of IBOR reform, Company X and the lender have agreed to change the interest rate on the loan to SONIA (Sterling Overnight Index Average) plus a margin of 4.3%. The additional fixed margin of 0.3% approximates the spread between the 6-month GBP LIBOR benchmark and SONIA.

Question A.1

Company X has concluded that there will be no immediate profit and loss impact arising from the change to the interest rate. Instead, the effective interest rate on the borrowing is changed prospectively to SONIA + 4.3%.

Is Company X correct in its conclusion?

Answer

Yes, so long as the change to SONIA plus an additional margin of 0.3% is **economically equivalent** to 6-month GBP LIBOR, the effective interest rate on the borrowing will be revised to reflect the change prospectively and as such there will be no immediate recognition and measurement impact.

Question A.2

How should Company X assess and document whether the changes are “economically equivalent”?

Answer

The assessment of whether a change is deemed “economically equivalent” in accordance with the guidance provided by the IASB is principles-based³. There are no bright lines and nor is there a requirement to perform a quantitative analysis when making an assessment. If the only reason for changing the interest rate is to affect IBOR reform, and the arrangement is at arms-length, then arguably the change will be economically equivalent.

Further, consistent with IASB guidance, it may be possible to conclude that a change is economically equivalent where the interest rate on a borrowing after the replacement is substantially similar to the interest rate per the IBOR benchmark immediately preceding the replacement⁴.

³ AASB 9.5.4.8 and AASB 9 Basis for Conclusions BC5.315-317

⁴ AASB 9 Basis for Conclusions BC5.315(a)

For example, assume that at the date of change the 6-month GBP LIBOR rate is 0.4% making the total interest rate on Company X's borrowing equal to 4.4% (0.4% + 4% margin). On the same date, SONIA (the new reference rate replacing GBP LIBOR) is equal to 0.05%. Immediately following the change to SONIA + 0.3% the total interest rate on the borrowing becomes 4.35% (0.05% + the additional spread of 0.3% + the original spread of 4%).

The rate immediately preceding the change, being 4.4%, is substantially similar to the rate after the replacement of the IBOR benchmark, being 4.35%. Company X can therefore conclude that the change was done on an economically equivalent basis.

Regardless of how the analysis is performed, organisations impacted by IBOR reform should document their assessment of whether the changes made to borrowings and other financial arrangements are on an economically equivalent basis.

Question A.3

As a result of IBOR reform, could an IBOR benchmark be replaced with an ABR without any change to the fixed margin? For example, if the interest rate on a borrowing was GBP LIBOR + 4% and this was replaced by SONIA + 4%, could this be considered economically equivalent?

Answer

Most likely no. The two rates have different characteristics and are quantitatively different from each other. IBOR is a term rate which applies to different time periods of interest, whilst most ABRs are overnight rates. IBOR, such as GBP LIBOR, is a rate transacted between banks for a certain term, so it generally includes some credit risk, whereas an ABR such as SONIA is nearly risk-free. Finally, IBOR is a forward-looking rate, in that the rate is set in advance and applied to a future period, whereas ABR is a backward-looking rate and can be calculated for a given period only at the end of that period.

So, when we switch from IBOR to ABR, it is unlikely that IBOR flat will be replaced with ABR flat. The different characteristics of each should be considered and will often result in a fixed spread being added to compensate for these differences. In addition, interest reset periods, reset dates, or the number of days between coupon payment dates may need to be updated to reflect these differences.

Question A.4

What if Company X were planning to change its floating IBOR exposure to a fixed rate. Can the practical expedient be applied?

Answer

No, exchanging a floating IBOR rate for a fixed rate would not be a change required to effect the reform – i.e., changing to a fixed rate would not be a way to implement IBOR reform.

Changes in addition to those required by IBOR reform

Scenario B

Assume the facts are the same as those of Scenario A except that the credit worthiness of Company X has improved and, as a result, they have successfully negotiated a *decrease* in the fixed margin of 1% such that the new interest rate on the loan is SONIA plus 3% (reflecting the current market rate of interest for Company X).

Company X has concluded that because the new rate of interest reflects **current market rates** it can be considered “economically equivalent” and as such there will be no recognition and measurement impact.

Question B.1

Is Company X correct in its conclusion?

Answer

No. In this scenario the changes made to the loan go further than those needed just to implement IBOR reform. In this case a change has been made to the credit spread on the loan to reflect changes in the credit quality of Company X resulting in the new rate not being economically equivalent to the previous rate.

Question B.2

What are the recognition and measurement implications where a change is not considered to be economically equivalent?

Answer

If the change in rate includes factors other than the changes required by IBOR reform the accounting consequences may be complex and consultation with your advisor is recommended. The accounting analysis may require consideration of several issues, including, but not limited to, whether the additional changes to the interest rate represents a substantial modification or, in some circumstances, whether there is a partial derecognition of the loan.

Hedge accounting

Scenario C

Continuing with the above fact pattern, assume Company X has swapped the floating rate GBP borrowing back to a fixed rate in its functional currency of AUD using a cross currency interest rate swap (CCIRS). The swap is designated in a hedge accounting relationship with the borrowing. Prior to IBOR reform, the CCIRS terms are such that it receives 6m GBP LIBOR + 4% and pays 6% in AUD.

Question C.1

Assume that the GBP LIBOR benchmarks in both the borrowing and the swap are replaced with SONIA plus an additional spread of 0.3% **at the same time**. The change is deemed to be economically equivalent.

What is Company X required to do?

Answer

In addition to Company X updating the effective interest rate on its borrowing to SONIA + 4.3%, they will also amend the formal designation of the hedging relationship to reflect the changes that are required by IBOR reform. For example, the hedging derivative should now be defined as a CCIRS that receives SONIA + 4.3% and pays 6% in AUD.

The changes required to the hedge relationship and hedge documentation will depend on the hedge type.

For a **fair value hedge** the designation and documentation will need to be adjusted for changes in the hedged risk (i.e., replacing references to GBP LIBOR with SONIA), hedged portion (if applicable) and for changes in the hedging instrument (i.e., now defined as a swap that receives SONIA + 4.3% and pays 6% in AUD). In addition to these changes, for a **cash flow hedge**, the organisation will also need to update the hedged item and associated hypothetical derivative used to calculate hedge ineffectiveness.

These changes need to be made by the end of the reporting period during which the IBOR reform changes were made.

In this scenario hedge accounting can continue and no additional hedge ineffectiveness is expected to arise.

Question C.2

Can hedge accounting continue if additional changes are made to the hedged item and/or hedging instrument over and above those required by IBOR reform?

Answer

It depends. If changes are made to the hedge relationship over and above those changes required by IBOR reform, for example, the interest rate on the borrowing is reset to current market rates, Company X must first apply the requirements of AASB 9 to determine whether the hedging relationship needs to be discontinued.

In accordance with AASB 9, a hedge relationship is discontinued when either the risk management objective changes or when the qualifying criteria are no longer met. This may be the case where the changes to the borrowing result in its derecognition. The derecognition of the hedged item would necessitate discontinuation of the hedge relationship.

If hedge accounting is discontinued because of the additional changes, then the Phase 2 amendments do not apply. A new hedging relationship may be established if it meets the hedge accounting requirements in AASB 9.

If hedge accounting is not discontinued, then Company X applies the Phase 2 amendments. In this case the organisation amends the formal hedge designation to reflect the changes solely relating to IBOR reform by:

- Updating the hedged risk from the GBP LIBOR benchmark to SONIA
- Amending the description of the hedged item (reflecting the economic equivalent rate), and
- Amending the description of the hedging instrument.

As the hedge documentation is only amended for the changes required by IBOR reform, any changes made to the relationship over and above those required by IBOR reform will impact hedge ineffectiveness going forward.

Question C.3

What are the accounting implications if changes made to the borrowing and CCIRS, required due to IBOR reform, occur at different points in time?

Answer

For **cash flow hedges**, there may be a mismatch in timing between when the hedged item (the GBP borrowing in our scenario) and hedging instrument (the CCIRS in our scenario) are amended due to IBOR reform. Either the hedged item or the hedging instrument will change first. Whatever the case may be, the changes need to be reflected in the hedge documentation.

Under the Phase 2 amendments, changes to hedge documentation can be made more than once. For instance, if the hedging instrument (CCIRS) changes first the organisation will need to update the documentation to amend the description of the instrument. Then, when the hedged item (borrowing) changes, the organisation will need to amend the description of the hedged item and the hedged risk.

The mismatch in timing may result in different fixed spread being applied to the hedged item and hedging instrument. For instance, the borrowing may be adjusted by SONIA + 0.5% whereas for the CCIRS, the new rate may be SONIA + 0.3%.

As a result of the difference in the fixed spread, some hedge ineffectiveness may arise (see Questions C.4 and C.5).

This is not expected to be an issue for **fair value hedges** of fixed interest rates exposure, because the IBOR reform will not result in a change to the fixed rate of the hedged item. As such, the impact will be limited to updating the hedge documentation for changes in the hedged risk (e.g., from GBP LIBOR to SONIA) and amending the description of the hedging instrument.

Question C.4

For cash flow hedges, where the borrowing and CCIRS are amended at different times resulting in different economically equivalent rates what is the impact on the hypothetical derivative?

Answer

As noted in Question C.3, if there is a mismatch in the timing of changes to the hedged item (borrowing) and the hedging instrument (CCIRS) due to IBOR reform, the fixed spread applied to the new ABR at the time of transition can be different.

For example, assume the borrowing is adjusted by replacing GBP LIBOR with SONIA + 0.5% whereas the CCIRS is amended to SONIA + 0.3%.

If the **hedged item** (borrowing) is changed first, the hedged risk will need to be updated and the hypothetical derivative should reflect the fixed spread in the hedged item – i.e., SONIA + 0.5%.

If the **hedging instrument** (CCIRS) is changed first, the hedged risk cannot be changed as the borrowing will continue to reference GBP LIBOR. The hedged risk and the hypothetical derivative will only change when the hedged item is changed.

This is likely to result in some hedge ineffectiveness driven by the difference between the fair value of the hedged item compared to the fair value of the hedging instrument given that there is no practical expedient for the measurement of hedge ineffectiveness. This ineffectiveness is due to hedging a GBP LIBOR exposure with a swap referencing SONIA. There is still an economic relationship between the two rates so hedge accounting can continue. When the hedged item eventually changes, the ineffectiveness will be reduced but may not be eliminated because the fixed spread applied at that time may be different to what was applied to the swap.

Question C.5

Assuming that changes to the fixed spread on the borrowing and CCIRS due to IBOR reform are different but happen around the same time:

- i) Is it possible for both changes be considered “economically equivalent”? and
- ii) What is the impact on hedge accounting?

Answer

With respect to (i), yes as the concept of economic equivalence is principles based and there are no bright lines against which to assess a change – see Question A.2. Judgement needs to be applied to determine whether the changes made are economically equivalent and it will be important to understand and document the reasons for any differences.

With respect to (ii), for cash flow hedges, assuming both changes are considered economically equivalent, the hypothetical derivative should reflect the adjustment made to the hedged item (borrowing). Similar considerations are discussed in Question C.4. As a result, some ineffectiveness may arise as the cash flows on the borrowing may not perfectly match the cash flows on the CCIRS.

Leases

Question D.1

Assume Company X is a lessee in a lease agreement where the payments are linked to an IBOR benchmark. What are the implications for Company X if there is a change in lease payments due to IBOR Reform?

Answer

If the modification is a direct consequence of IBOR Reform and the new basis for determining lease payments is economically equivalent to the previous basis, the lessee remeasures the lease liability using the guidance for a change in an index or a rate⁵, with an adjustment to the right-of-use asset.

If the change in rate reflects changes other than the IBOR Reform, lease modification accounting⁶ applies.

⁵ Refer to AASB 16, paragraph 42.

⁶ Refer to AAB 16, paragraphs 44 to 46.

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