KPMG

Asset Management Valuation and IBOR

Your Partner For What's Next

Speakers

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IBOR Reform
- Accounting Implications

Terence Coveney

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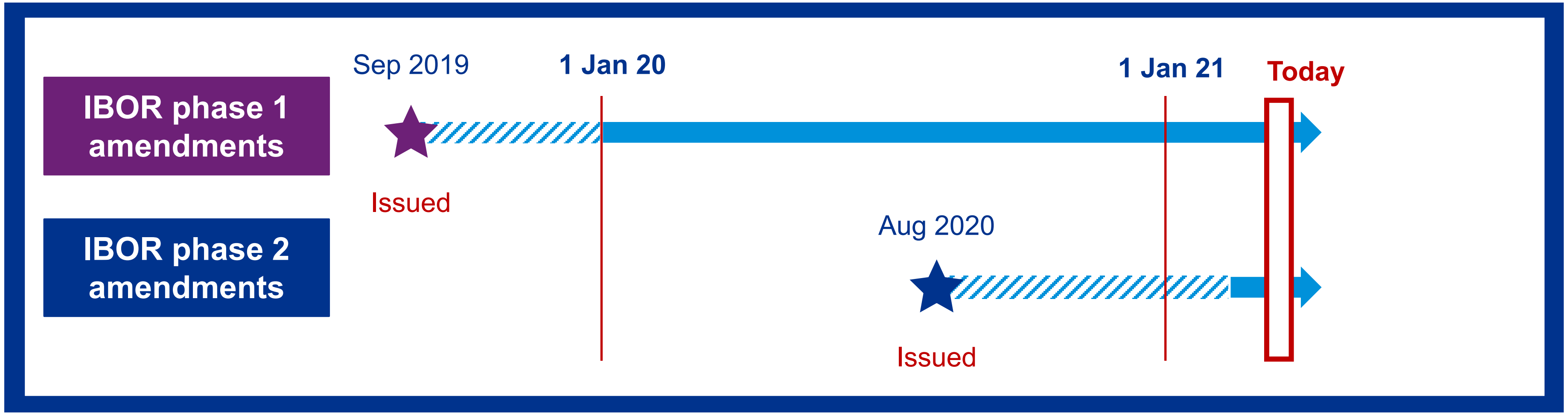
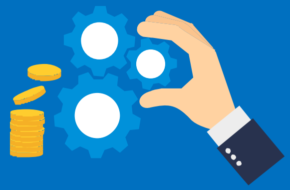
Why are we discussing this topic?

1	Reforms of interest rate benchmarks, including the replacement of interest rate benchmarks with alternative benchmark rates (ABRs) are expected to be mostly complete by the end of 2021.
2	The International Accounting Standards Board (the Board) has completed its project on the financial reporting impacts arising from the global reform of benchmark interest rates.
3	Understanding the impact of IBOR reform and the amendments issued by the Board is essential for upcoming period ends.

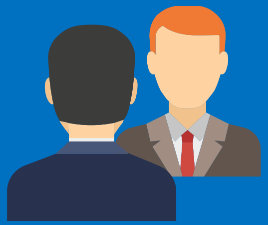
Where we stand now…

IBOR phase 1 amendments are already effective and IBOR phase 2 amendments can be early applied.





Is the entity appropriately applying phase 1 amendments?



Has the entity opted to early adopt phase 2 amendments?

- If yes, is the entity appropriately applying phase 2 amendments?
- If no, how does the entity account for IBOR transition (if any)?

Market Update, in brief

5 March 2021: The FCA has announced the dates that panel bank submissions for all LIBOR settings will cease, after which representative LIBOR rates will no longer be available. This is an important step towards the end of LIBOR, and the Bank of England and FCA urge market participants to continue to take the necessary action to ensure they are ready.

(see full announcement here)

ISDA has published the following statement in response to today's announcement by the UK FCA on the future cessation and loss of representativeness of the LIBOR benchmarks.

"Today's announcement constitutes an index cessation event under the IBOR Fallbacks Supplement and the ISDA 2020 IBOR Fallbacks Protocol for all 35 LIBOR settings. As a result, the fallback spread adjustment published by Bloomberg is fixed as of the date of the announcement for all euro, sterling, Swiss franc, US dollar and yen LIBOR setting"

(see full announcement here)

The issuance of IBOR phase 2 amendments

IBOR Phase 2 Amendments
issued on 27 August 2020

Modification of a financial instrument

Additional reliefs for hedging relationships

New disclosures

Modification of a lease

Modification of a financial asset and a financial liability – practical expedient

Phase 2 amendments – IFRS 9.5.4.7

As a practical expedient, an entity shall apply paragraph B5.4.5 to account for **a change in the basis for determining the contractual cash flows of a financial asset or financial liability** that is required by interest rate benchmark reform. …

What is "a change in the basis for determining the contractual cash flows of a financial asset or financial liability"?

- A reference to 3M GBP LIBOR is replaced with SONIA
- Since 2 October 2019, EONIA is calculated as €STR + 8.5 bps
- An existing fallback clause is triggered

Modification of a financial asset and a financial liability – what is meant by "required by the reform"?

Phase 2 amendments – IFRS 9.5.4.7

As a **practical expedient**, an entity shall apply paragraph B5.4.5 to account for a change in the basis for determining the contractual cash flows of a financial asset or financial liability that is **required by interest rate benchmark reform**. …

The change in the basis for determining the contractual cash flows is required by interest rate benchmark reform if both of the following two conditions are met.

1. The change is ***necessary as a direct consequence of interest rate benchmark reform***.
2. The new basis for determining the contractual cash flows is ***economically equivalent*** to the previous basis (i.e. the basis immediately preceding the change).

Modification of a financial asset and a financial liability - the change that is necessary as a direct consequence of IBOR reform

What is the meaning of "**the changes that are necessary as a direct consequence of interest rate benchmark reform**"?

1 The change is ***necessary as a direct consequence of interest rate benchmark reform***.

Phase 2 amendments encompass changes that "are required to implement the reform" or "necessary as a direct consequence of the reform".

It does not mean that **the reform itself is mandatory** – e.g. the reform is required by law or regulation.

The practical expedient is **not limited to only particular ways of effecting the reform**, provided the reform is consistent with the description in paragraphs 6.8.2 of IFRS 9 – i.e. the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations set out in the Financial Stability Board's July 2014 report 'Reforming Major Interest Rate Benchmarks'. [IFRS 9 BC5.313]

Modification of a financial asset and a financial liability - economically equivalent basis

Meaning of "**economically equivalent**" basis.

IBOR

- ✓ Term rate – 1M, 3M, 6M, 12M …
- ✓ Includes some credit risk
- ✓ Forward looking

ABR

- ✓ Overnight interest rate
- ✓ Risk free rate (or at least much less credit risk)
- ✓ Backward looking

Examples of an economically equivalent change

- the replacement of an existing IBOR used to determine the contractual cash flows of a financial instrument with an ABR plus the addition of a fixed spread that is necessary to compensate for a basis difference between IBOR and ABR.
- the implementation of IBOR reform by changing the method used to calculate the interest rate benchmark with the addition of a fixed spread that is necessary to compensate for a basis difference between IBOR and ABR.
- changes to the reset period, reset dates, or the number of days between coupon payment dates that are necessary to implement the reform of an interest rate benchmark.
- the addition of a fallback provision to the contractual terms of a financial instrument to enable any of the changes described above to be implemented.

Modification of a financial asset and a financial liability – applying B5.4.5

When a modification occurs…

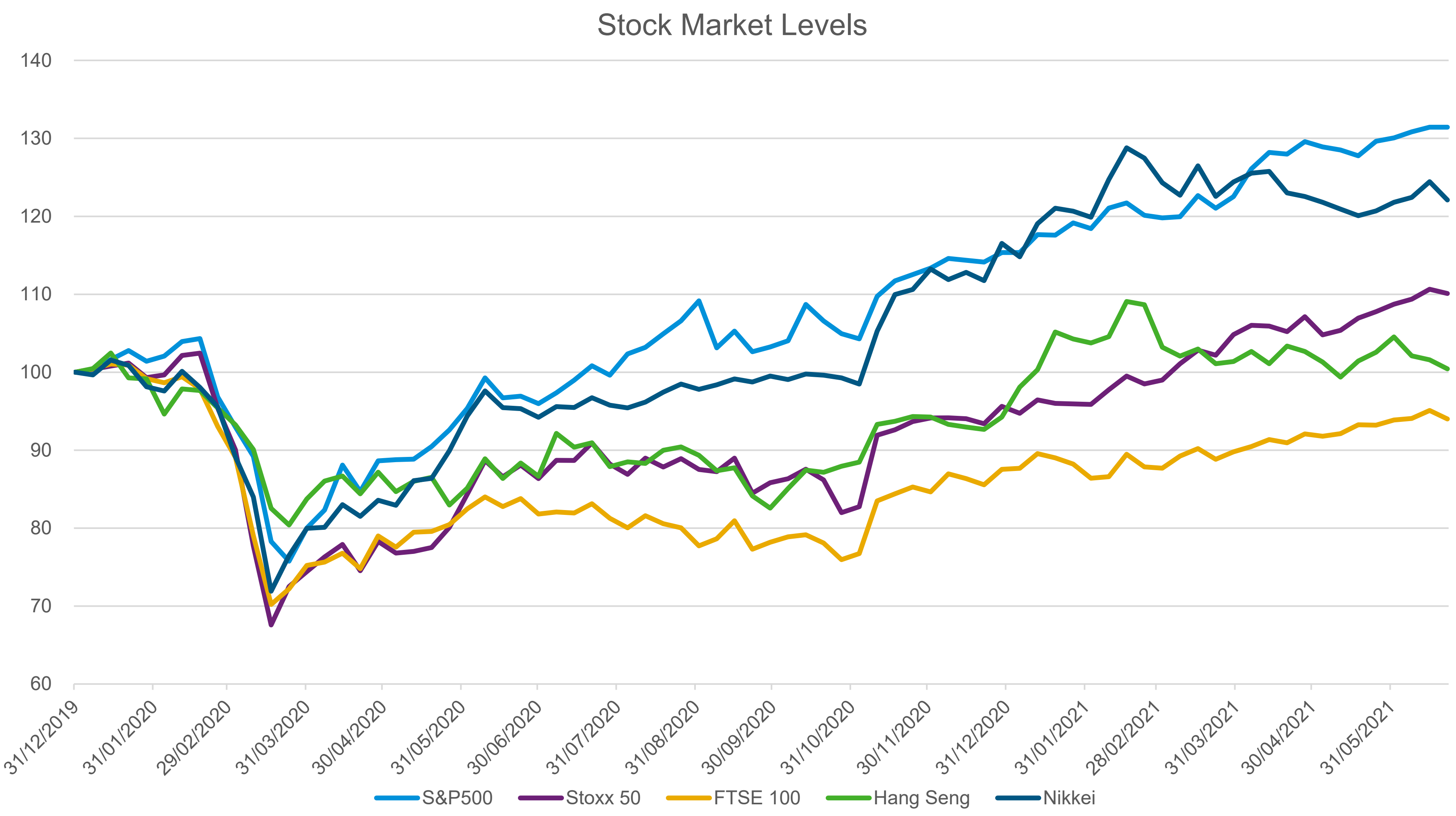
		Available guidance	For IBOR changes
IFRS 9 5.4.3	When the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in derecognition	• Recalculate the gross carrying amount of the financial asset as below: “Renegotiated or modified contractual cash flows” discounted at the “original effective interest rate” • Recognise a modification gain or loss in profit or loss.	✗
IFRS 9 B5.4.5	For floating-rate financial assets and floating-rate financial liabilities	• Periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate. • Normally has no significant effect on the carrying amount of the asset or the liability.	✓
IFRS 9 B5.4.6	If an entity revises its estimates of payments or receipts	• Recalculate the gross carrying amount of the financial asset or amortised cost of the financial liability as below: “Re estimated contractual cash flows” discounted at the “original effective interest rate” • The adjustment is recognised in profit or loss as income or expense.	✗

Market Performance and Major Issues

James Calvert

Director
Corporate Finance

Stock Market Performance by Country



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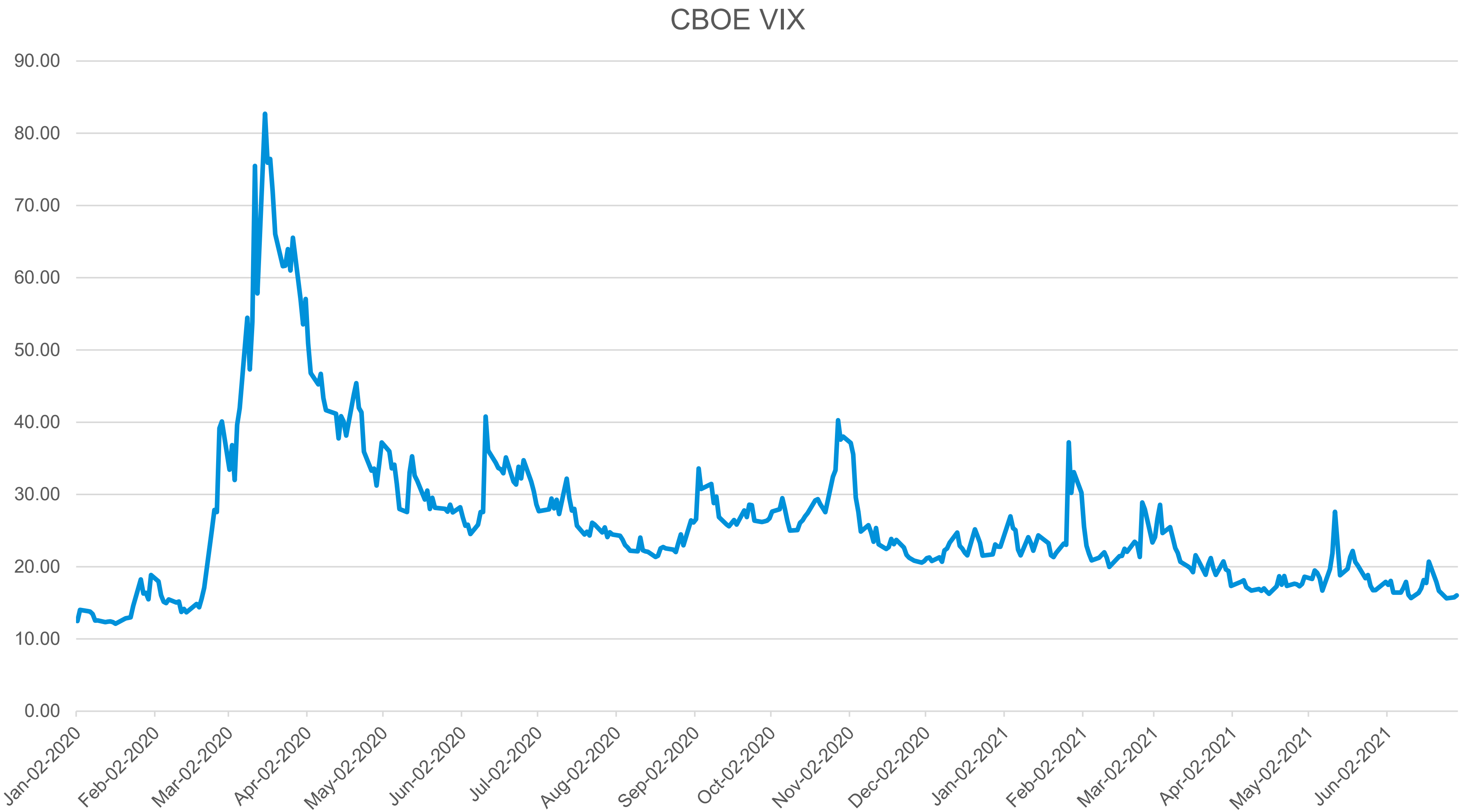
Volatility


CBOE VIX
90.00
80.00
70.00
60.00
50.00
40.00
30.00
20.00
10.00
0.00
Jan-02-2020
Feb-02-2020
Mar-02-2020
Apr-02-2020
May-02-2020
Jun-02-2020
Jul-02-2020
Aug-02-2020
Sep-02-2020
Oct-02-2020
Nov-02-2020
Dec-02-2020
Jan-02-2021
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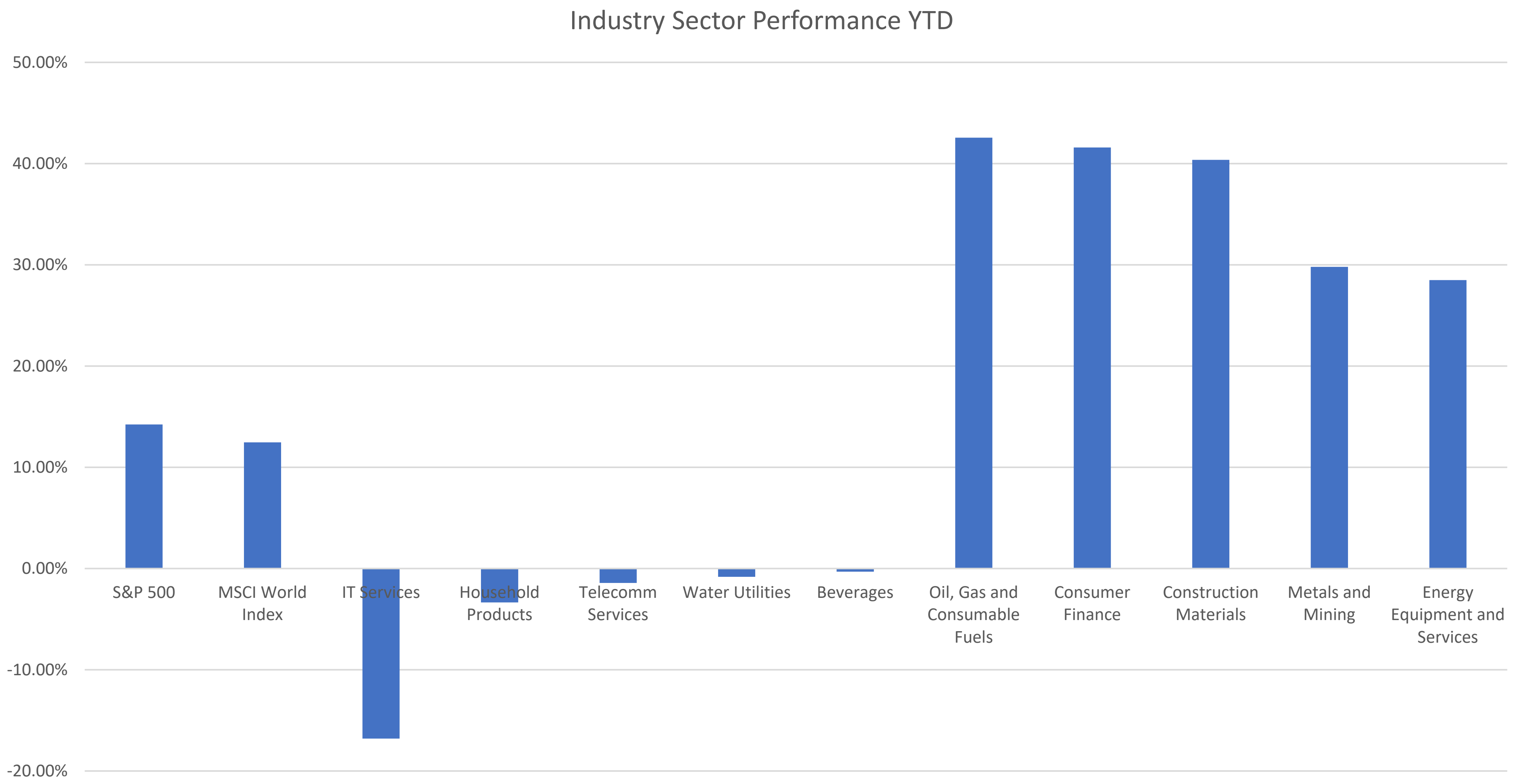
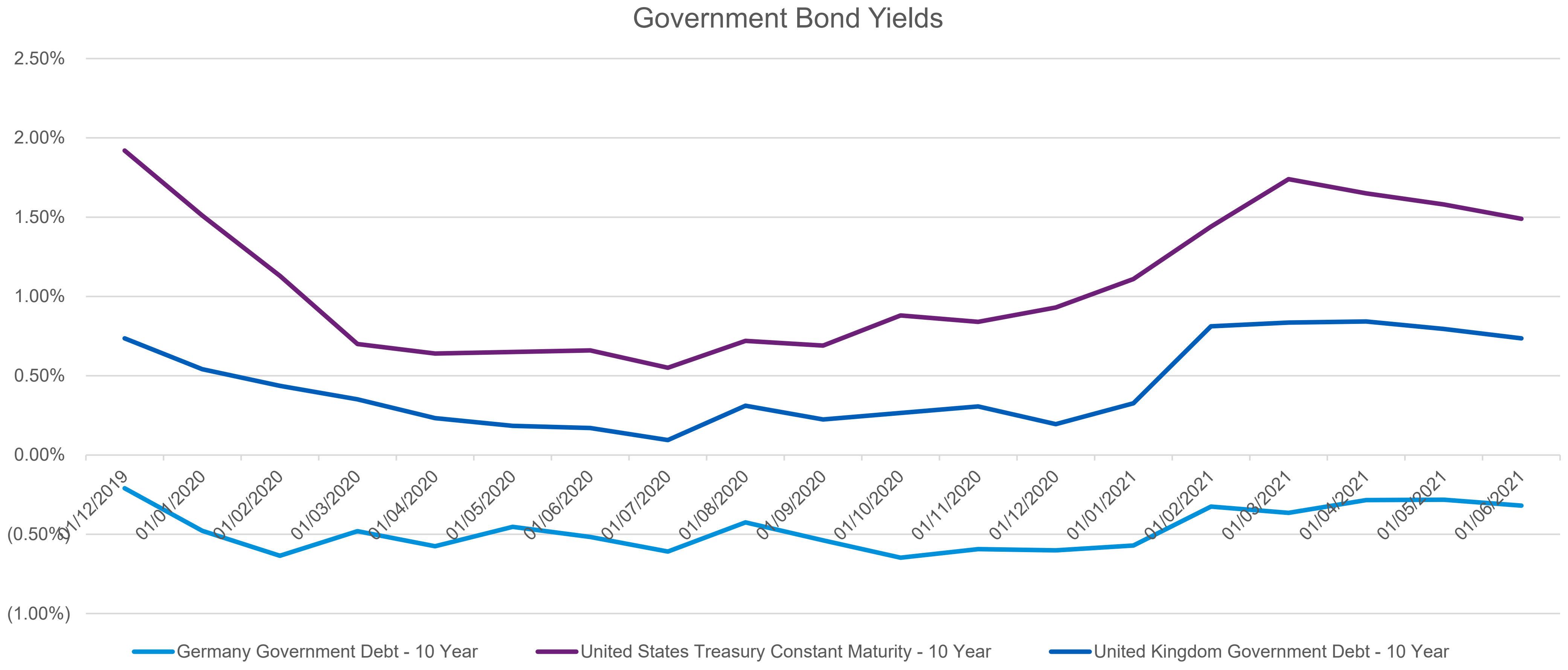
Mar-02-2021
Apr-02-2021
May-02-2021
Jun-02-2021

Stock Market Performance by Sector



Government Bond Yields



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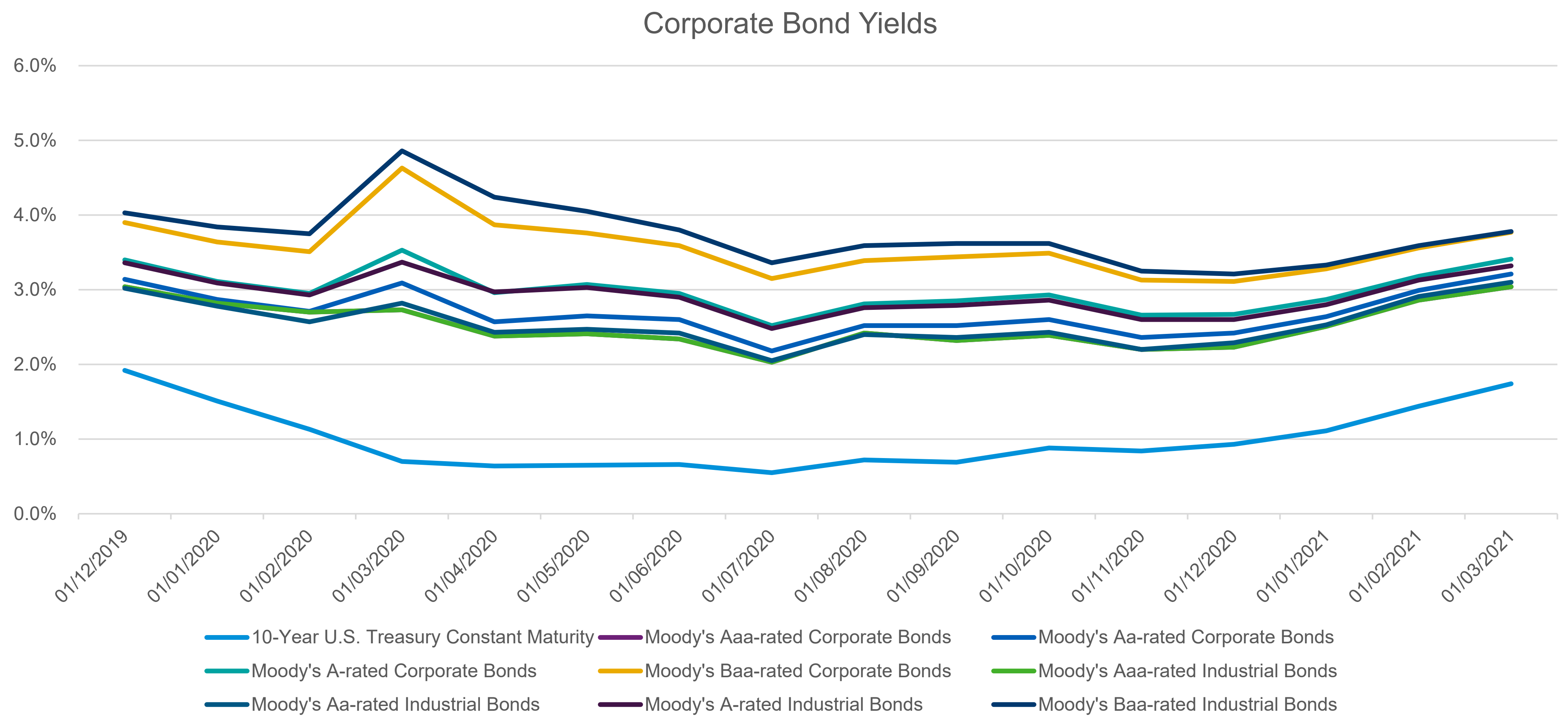
Corporate Bond Yields



Major Issues

- Covid
- ESG
- Inflation / interest rates
- SPACS
- Cryptocurrencies
- Politics

Considerations for Valuation

Francisco Jimenez
Director
Financial Instruments

Current Market Developments

1

Market Liquidity continue to increase

Increase in market liquidity since start of 2020.
Government stimulus plans helping to boost market liquidity.

2

Increase of Market Volatility & Uncertainty in Dividends Projections

Market volatility has been decreasing since the spike in March 2020 due to COVID-19, but it still remains higher than pre-pandemic times.
The number of volatility spikes has remained high in 2021.

3

Relatively Positive Outlook in Credit Risk

Credit spreads for investment grade, non investment grade fixed income securities and structured products have dropped significantly compared to when COVID-19 first started – but credit risk exposure is still present
Government stimulus and regulator policies have provided spaces for credit market recovery

Impacted Markets

- Fixed Income
- Interest Rate
- FX
- Credit

- Fixed Income
- Interest Rate
- FX &Equity
- Credit

- Fixed Income
- Credit

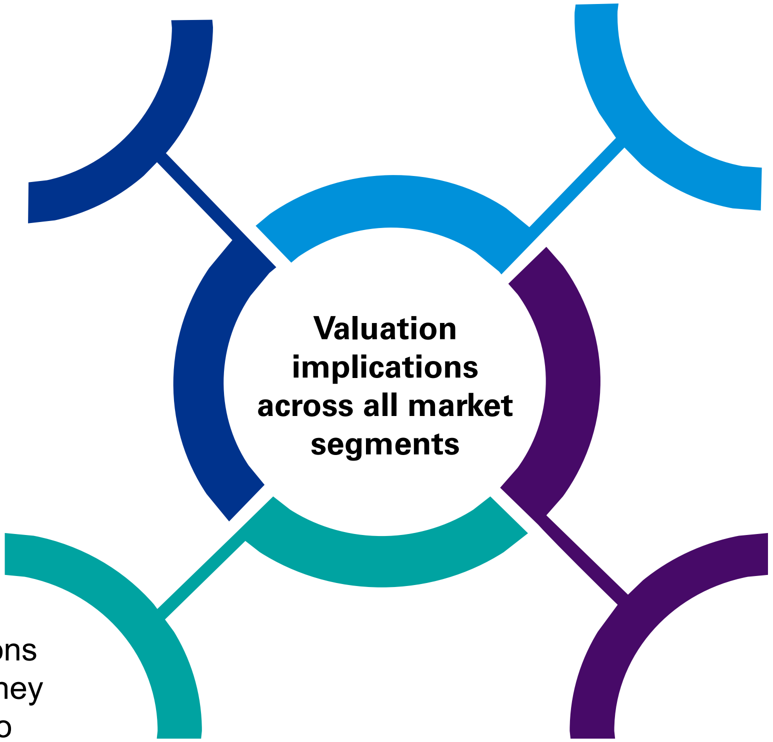
Growing Valuation Challenges

Fixed Income

- Determining a robust fair value due to fluctuating external price quality
- Model based valuation and maintaining of consistency
- Uncertainty and implications on the prices for structured finance assets (e.g. CLOs)

Interest Rate

- Model stress due to low interest rates levels and varying volatilities
- One sided exposure leading to unobservable inputs (option volatilities)
- Challenges in curve construction processes and increasing importance of multicurve valuation



FX and Equity

- Increased valuation uncertainty due to options shifting deep in the money or out of the money
- Model stress especially on calibration due to volatility levels
- Snapshot valuations requiring closer monitoring due to high intraday movements

Credit

- Credit spreads for CDS curves have been decreasing significantly since March 2020
- Impact on valuation adjustments (CVA/DVA) and wrong way risk.
- Maintaining hedge ineffectiveness

IBOR Transition

Key Takeaway
On 5 March 2021, the Financial Conduct Authority (FCA) UK 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. Alternative reference rates must be implemented and ready to use by this date.

Liquidity Concerns
While there was a positive trend in the adoption of SOFR derivatives during 2020, this is off a very low-base and the vast majority of activity, over 90 percent of contracts traded, remained concentrated in LIBOR as of the end of 2020.

ARRC Transition Progress
The ARRC released the Guide to Published SOFR Averages in May 2021, providing market participants with key information on the LIBOR transition, including how the published SOFR Averages can be used and what factors market participants should consider before selecting the alternative rate they use.

Early Shifting of Libor
From early this year, it is considered by global clearing houses whether to shift interest-rate derivatives away from the London interbank offered rate before the benchmark expires – it is believed that the early moves could protect companies from turbulence during tight liquidity in the final days of Libor.

SEC's New Valuation Practice Framework

On 3rd December 2020, the Securities and Exchange Commission (SEC) voted to propose a new rule 2a-5 and new rule 31a-4 under the Investment Company Act of 1940 establishing an updated regulatory framework for fund valuation practices. Compliance with the new rules will not be required until 18 months after the effective date.

Determining Fair Value in Good Faith 1

Additional Requirements if a Valuation Designee Is Used 2

SEC Publication: Rule 2a-5

When the board designates a valuation designee:

Quarterly Reporting

- Quarterly valuation reporting is required
- The reporting must include:
  - Any reports or materials requested by the board related to the fair value of investments
  - A summary or description of material fair value matters that occurred in the prior quarter, including:
    1. Any material changes in the assessment and management of material valuation risks, including any material changes in conflicts of interest
    2. Any material changes or deviations of established fair value methodologies
    3. Any material changes to or material events in the selection and oversight process for pricing services used

Annual Reporting

- On an annual basis, the designee must provide the board an assessment of the adequacy and effectiveness of the valuation in writing
- This entails the designee's process for determining the fair value of the designated portfolio of investments including:
  - A summary of the results of the testing of fair value methodologies
  - An assessment of the adequacy of resources allocated to the process for determining fair value, including any material changes to the roles or functions of the person responsible for determining fair value

*The valuation designee will also be required to promptly notify the board, at a time determined by the board but **no more than five business days** after the designee becomes aware, of material matters that may affect the fair value of the portfolio of investments

(Source: https://www.sec.gov/news/press-release/2020-302)

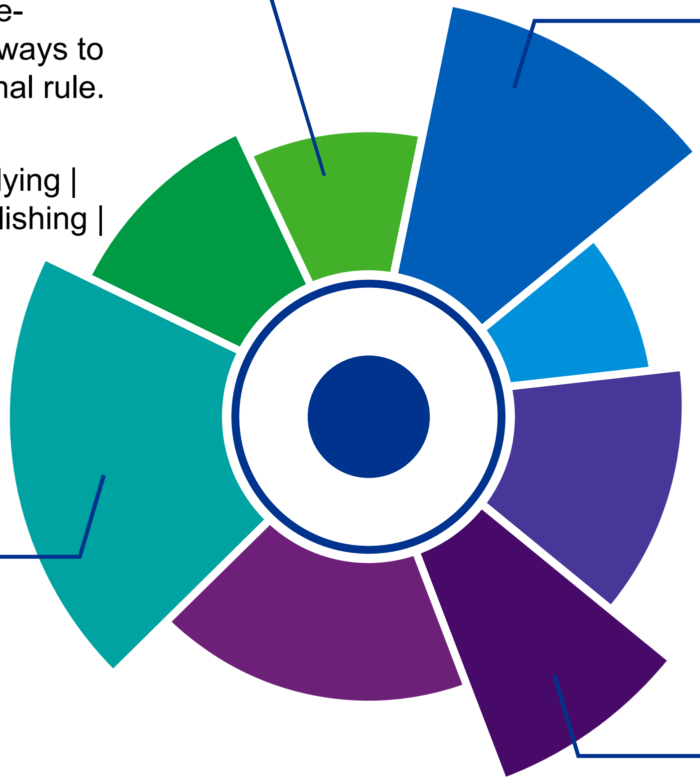
Additional Requirements if a Valuation Designee Is Used

SEC Expectation for Boards oversight responsibilities

Boards need to work with the investment adviser to re-evaluate valuation policies and procedures, look for ways to strengthen its oversight model in the context of the final rule.

The final rule consists of action words which include:

Designating | Assessing | Managing | Selecting | Applying | Overseeing | Evaluating | Testing | Identifying | Establishing | Monitoring | Approving | Maintaining



Specification of Functions

Use of Valuation Committees & Reasonable Segregation from Portfolio Management

Board Reporting

Including certain periodic reports and prompt notification and reporting on matters that materially affect the fair value of fund investments

Guidance on Obtaining the Assistance of Others

(Source: https://www.sec.gov/news/press-release/2020-302)

Questions & Answers

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