IFRS Today

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PODCAST TRANSCRIPT

IBOR reform – Phase 2 final amendments

Speakers

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Colin

Welcome: My name's Colin Martin; I'm a partner here at KPMG in the UK. I'm joined today by Stewart Hagell, one of our foremost specialists in corporate treasury, to explore the global reform of financial benchmarks and the impacts this will have on financial reporting. So, while Stewart can talk about the effects on corporates, I will bring some insight about what I have seen in the banking sector.

Stewart

Yes. Hi there, Colin.

So, during my work with corporates, I've seen the financial world getting to grips with the reform of some of its key benchmark rates, and financial reporting is one of the areas that will be significantly impacted by this.

Although companies have had to focus on the urgent matter of dealing with the global COVID-19 pandemic, regulators and central banks have been clear that this is no excuse for any let-up in preparing for the IBOR transition process.

The Bank of England's working group has said that as soon as the disruption caused by the pandemic begins to stabilise, it will be "intensifying communication" on this in order to stick to the timetable it previously set.

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Colin

And the International Accounting Standards Board, as well, has been maintaining its momentum, and has issued amendments to Phase 2 of its IBOR reform.

We'll talk more about those phases in a minute. But – in a nutshell – the Board's aim has been to ensure that the financial statements only present the true economic effects of the reform, by providing targeted reliefs to ease the accounting and thereby reduce any 'noise' surrounding the change. To achieve this, the Board has broken out the IBOR project into two phases and has provided a series of exemptions from regular rules to make that transition easier.

Phase 1 was focused on the unknowns – what to do immediately in the anticipation of IBOR reform (in the presence of uncertainty) – and it focused on hedge accounting issues.

Phase 2 is what to do when the changes actually occur, which is expected to be soon, and may even be happening in some jurisdictions already.

Stewart

Before we dive into some of the key points we face here, it might be worth briefly going back over why all of this change is necessary?

Colin

Yes. And the issue was originally about the liquidity of benchmark rates. Don't forget that these are hypothetical offered rates, not necessarily based on actual transactions. The benchmarks were often based on where a bank thought it could lend, not where it necessarily did lend. Coupled with lack of governance around certain submission processes, the result was the LIBOR scandal.

And since then, the world has been moving to real, actually used rates and we're nearing the end of that replacement process. And we'll end with a real representation of the risk-free borrowing rate on any given day.

Stewart

So the proposed solution are these replacement rates based on real trades, which are being created on a country-by-country basis, with SONIA appearing to be the preferred replacement rate in the UK. These are expected to resolve the issues you've explained, Colin, but there are a number of side effects, including the complexity in accounting for this transition.

Colin

That's right. So, the IASB had to address this in their two phases.

As I mentioned, *Phase 1* was concerned with the run-up to transition, when there was still uncertainty.

Phase 2 deals with what happens when that uncertainty goes away. A LIBOR loan hedged with a LIBOR swap will have uncertainty in both of those components, but at some point the LIBOR loan and LIBOR derivative will switch to a SONIA rate, at which point there is no more uncertainty. But how do you mechanically make that change and reflect it in your hedging relationships? And even if you are not doing hedge accounting, how do you reflect the change in a loan from a LIBOR rate to a SONIA rate?

“Phase 2 deals with more than just hedge accounting. There appear to be five key areas of significant change that are worth highlighting.”

Stewart

Yes. And, of course, Phase 2 deals with more than just hedge accounting. There appear to be five key areas of significant change that are worth highlighting.

The first of these is *modification of loans* – a particular issue for corporates. IFRS 9 has detailed rules on modifying financial contracts, which can lead to a gain or loss being recognised in the income statement on modification. In this situation, modification is being forced on you as LIBOR is ceasing to exist – causing loan terms to require amendment. Phase 2 has introduced a practical expedient meaning that you wouldn’t have a modification gain or loss if the transition to a new alternative benchmark rate is necessary as a direct consequence of IBOR reform, and that change occurs on an ‘economically equivalent’ basis. An example of this could be where a fallback clause is activated, shifting you over to a new benchmark rate.

Colin

And it’s positive news in terms of hedge documentation as well. One of the key areas of change relates to that hedge documentation. Hedge accounting, as you know, is a very tightly regulated area. You have to document at the inception of a hedge a number of different things: mainly the hedging instrument, the hedged item and the hedged risk. But of those three components, they are all going to potentially change when you change a benchmark interest rate. Ordinarily, if you change formal hedge designations by rewriting the hedge documentation, that would constitute a cessation of hedge accounting, and that has real consequences in the accounting world. What the Board has done in Phase 2 is allow a series of exemptions from those regular rules that allow you to continue the hedge without interruption. You can change the formal designation to reflect the changes that are required by the IBOR reform. If you had a LIBOR loan hedged for LIBOR risk, you can update the hedge documentation to specify SONIA risk, for instance.

Stewart

So this ability to amend your hedge documentation is more positive news and will be especially relevant to corporates. You can now shift contracts over to a new reference rate without the need to de-designate hedges, which previously created significant accounting complexity and potential ineffectiveness.

Colin

Absolutely, it provides not only practical relief, but also reflects the true economics of IBOR reform.

But there’s another important component around the hedge mechanics itself. Even if a hedging relationship can be continued without interruption, any hedge ineffectiveness should be recognised in profit or loss. Similarly to Phase 1, Phase 2 doesn’t provide any exceptions on the measurement requirements for hedged items and hedging instruments. Once the hedged risk or the hedging instrument switches to the new benchmark rate, they should be remeasured based on the new rate and be subjected to ordinary hedge accounting rules.

"The Board asked companies to disclose certain items so that the users of financial statements understand the effect of IBOR reform on that company's financial instruments and risk management strategy."

Stewart

That's right. And one other aspect to draw out with the Phase 2 amendments is that they are mandatory and retrospective, which could mean reinstating hedge relationships that have been previously discontinued due to changes required by the IBOR reform. This could occur, for example, if I converted my swap or loan to SONIA before Phase 2 is finalised, leading to a requirement to de-designate my LIBOR hedge relationships and then re-designate my SONIA-linked hedges. If Phase 2 had been applied earlier, I wouldn't have needed to do this. So, if the only reason to stop hedging was IBOR reform, I would reinstate my original hedge, assuming it is still in accordance with my risk management strategy. This avoids the unpleasant accounting consequences of how to stop hedging between Phases 1 and 2.

Colin

And just to round all of these key changes off. As always when the Board introduces changes like this, there are new disclosures to make.

The Board asked companies to disclose certain items so that the users of financial statements understand the effect of IBOR reform on that company's financial instruments and risk management strategy. In particular, they asked for disclosure of:

- how the company is managing the IBOR transition, its progress at the reporting date and the risks arising from the transition;
- quantitative information about the financial instruments that are subject to IBOR reform at the end of the reporting period, showing them separately by each significant interest rate benchmark; and
- to the extent that IBOR reform has resulted in changes to the company's risk management strategy, what those changes are and how it is managing these risks.

So, in conclusion, for banks: interest rates are fundamental to everything they do. So the financial reporting aspect of IBOR reform is usually a smaller part of a much larger project. And most critically, it's important to integrate the financial reporting component effectively and on a timely basis into the wider project that the bank will be running.

And much of the change when it comes to financial reporting is within the bank's control. The banks themselves will trigger the end of Phase 1 when they eliminate any uncertainty from the IBOR reform. And since they are the lenders, they have a lot of control over the timing of how they renegotiate their loans, so they can prepare and schedule their implementation of these IBOR reform rules.

Stewart

Yes, and for a corporate, whilst you are often in a position of being a market taker instead, I'd recommend being proactive in understanding what your potential exposures are to IBOR, and approaching your banks and lenders to discuss the benchmark changes as soon as possible. The specific changes being made to your debt and related swaps, and the corresponding timing of these, will have an impact on your accounting result.

It's also worth considering the ability of your current accounting and treasury systems to deal with these benchmark changes. Especially given that new rates may be set retrospectively, unlike IBOR currently. Understandably, your efforts responding to the impacts of the global pandemic may have affected your preparations for the benchmark change. But, as we have seen, the regulators and central banks are sticking with their original schedules.

"All listeners – corporates or banks – should make sure they read and understand the Phase two amendments. They've been crafted very, very carefully and they are there to help make the transition easier."

Colin

And my final thought: for all listeners really, corporates or banks. Make sure you read and understand the Phase two amendments. They've been crafted very, very carefully and they are there to make the transition easier.

If you want to learn more about accounting for IBOR reform, type 'KPMG IFRS' into your browser and you'll be taken to KPMG's IFRS Institute home page, where you will find detailed guidance and insights on the changing face of financial reporting.

It just remains for me to thank you, Stewart, and everyone else for listening.

home.kpmg/IBORreform

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