Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas

LIBOR reform: changing the finance industry's most important number

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Interest rate benchmarks such as interbank offered rates (IBORs) play an important role in global financial markets. They are used to index trillions of dollars worth of financial products worldwide, such as loans, debt securities and derivatives. However, following concerns that IBORs are susceptible to manipulation, they are in the process of being replaced by interest rates based on observable market transactions. Relevant authorities are progressing toward replacing IBORs by the end of 2021. While most of the focus has been on the replacement of foreign currency benchmarks such as GBP Libor and USD Libor, the Australian benchmark rate, the bank bill swap rate (BBSW), could also be affected. In Australia, ASIC, APRA and the RBA are urging financial institutions to plan for IBOR transition. However, given the pervasiveness of IBOR benchmark rates in many debt and risk management instruments, IBOR reform will affect many companies across many industries.

What is IBOR reform?

For decades interbank offer rates - or IBORs, of which LIBOR and BBSW are examples - have served as the standard or benchmark unit of measurement for interest on many variable rate loans, debt instruments and derivatives, and for other measurement purposes such as inputs to valuations and setting performance hurdles. In most cases, the way IBORs are set is through indicative quotes provided by a group of panel bank members that is meant to represent the price at which they would lend to each other.

Following the financial crisis, issues were identified with the mechanisms used to determine IBORs. These issues included:

- an increased risk of market manipulation as the quotes were provided without the rigour and discipline of observable trades, and
- bank credit risk being included in the benchmark rates as they represented the price of interbank lending, meaning the rates were not pure measures of the time value of money (and credit risk of the banks increased disproportionately compared to other industries during the financial crisis).

The characteristics of these mechanisms undermined confidence in the reliability and robustness of these interest rate benchmarks and decreased liquidity in interbank unsecured funding markets.

In July 2014, the Financial Stability Board (FSB) published a report[1] setting out its recommendations for reform of IBORs. That report recommended IBORs be replaced by interest rates based on observable market transactions, ideally risk-free rates. Regulators in many jurisdictions have since taken steps to implement those recommendations. Notably, in July 2017 the FCA put an effective date to end Libor (or stop requiring quotes) by 31st December 2021.

In some jurisdictions, there is already clear progress towards replacing the existing interest rate benchmarks with alternative interest rates that are based on transaction data [see Table 1]. However, a number of technical issues regarding the successor rates remain. For instance, the established successor rates are overnight rates and successor rates have not been established for all of the same time periods (tenors) as the benchmark rates they are replacing (eg. LIBOR quotes typically used in contracts include the 1 month, 3 month and 6 month tenors).

[1] Financial Stability Board, Reforming Major Interest Rate Benchmarks, 22 July 2014. Accessed 24 June 2019.

Table 1. Examples of jurisdictions that are introducing fallbacks for current benchmarks

Jurisdiction	Benchmark	Risk Free Rate
USA	USD Libor	Secured Overnight Financing Rate (SOFR)
UK	GBP Libor	Sterling Overnight Interest Average (SONIA)
Australia	BBSW	Australian Overnight Interest Average (AONIA)
New Zealand	BKBM	TBA (likely late 2019)
Japan	Tibor	Tokyo Overnight Average Rate (TONAR)
Switzerland	CHF Libor	Swiss Average Rate Overnight (SARON)
Europe	Euribor	European Short Term Rate (€STR)

Globally, regulators have also been pressing the case for financial institutions and other large corporates to prepare for the transition away from IBORs.

In Australia, ASIC recently issued a statement, supported by both APRA and the RBA, urging financial institutions to plan for IBOR transition. However, given the pervasiveness of IBOR benchmark rates in many debt and risk management instruments (i.e. derivatives), IBOR reform will affect many companies in many industries.

How pervasive are IBORs?

Interest rate benchmarks such as interbank offer rates (IBORs) play an important role in global financial markets. The standardisation of financial products using benchmark interest rates reduces the cost of transacting and increases liquidity. The success of these rates has resulted in them being used to index trillions of dollars worth of a wide variety of financial products such as loans, debt securities and derivatives. Thus, benchmark rates form the backbone of financial markets. All other rates are derived implicitly or explicitly from benchmark rates.

Further, the rates are embedded in many valuation models and methods that are used to derive valuations for regulatory, accounting and tax purposes (including models used to value non-financial assets and liabilities).

What's happening in Australia?

In the Australian context, the local benchmark rate, the BBSW, is also referenced in most, if not all, local floating-rate debt agreements (see Table 2). While the BBSW is set based primarily on observable market transactions (thus meeting the reform recommendations), the rate itself still reflects the funding risk of a small group of banks. The difference between the risk components of the BBSW and those of the successor foreign risk free rates would make swaps between them unattractive, and would also result in less liquidity in local bond markets. So, while it was hoped that BBSW would continue, the reality is that market forces would result in a shift away from BBSW and into an equivalent risk-free rate (i.e. the Australian Overnight Interest Average, or AONIA).

However, many credit hungry financial institutions and large corporates also borrow money, enter into term loans, and issue debt in foreign debt markets which are deeper and more liquid than local AUD and NZD debt markets. Floating rate debt in foreign debt markets is usually indexed to one of the foreign IBOR rates. This debt is then hedged using derivatives to convert a foreign exchange and interest exposure to Australian or New Zealand dollars and rates.

Table 2. Financial Contracts Referencing Australian Dollar Interest Rate Benchmarks (published in *RBA Bulletin*, Interest Rate Benchmarks for the Australian Dollar, S Alim and E Connolly, 20 September 2018)

BBSW is referenced in:	**Amount outstanding**
Derivatives	$17 trillion*
Business loans	$300 billion
Debt securities	
– Non-government securities	$200 billion
– Asset-backed securities	$440 billion
– Semi government securities	$20 billion
The cash rate is referenced in:	
Derivatives	$7 trillion*

*The amount outstanding for derivatives are notional values; these are the total amounts on which the interest payments to be exchanged in the derivatives contracts are based.

What are the financial reporting impacts?

There are many potential impacts on financial reporting over the short and long term as markets transition to new benchmark rates. These include, but are not limited to, the following:

- Modifications of financial assets, financial liabilities and derivatives, including assessing whether modifications are extinguishments, and determining the appropriate accounting for changes in rates.
- Hedge accounting matters, including hedge documentation, effectiveness testing, redesignating relationships, and mismatches between changes in the hedge instrument and hedged item.
- Valuation model changes, including valuation of both financial and non-financial items.
- Other balance-sheet items, including leases, insurance, provisions etc.

Acknowledging the potential wide-ranging impacts of IBOR reform, in 2018 the International Accounting Standards Board (IASB) added a project to its agenda to consider the financial reporting implications of the reform. The IASB has set up its project in two phases:

- Phase 1 will consider the financial reporting impacts arising from the uncertainty regarding the successor rates.
- Phase 2 will consider the financial reporting impacts from implementing the transition to successor rates.

What is the IASB proposing for Phase 1?

The focus of this phase is on ensuring hedge accounting is not adversely affected by the uncertainties surrounding IBOR reform arising from:

- the operation of existing fallback provisions
- the replacement of the term reference rates and credit spreads, and
- whether IBORs will continue to operate as they have in the past as we get closer to December 2021 and the markets start to move away from IBORs.

These uncertainties may call into question the economic relationship between the hedging instruments and hedged items.

In May 2019, the IASB published an Exposure Draft, 'Interest Rate Benchmark Reform: Proposed amendments to IFRS 9 and IAS 39', with an accelerated comment deadline of 17 June 2019. These proposed amendments would enable hedge accounting to continue for certain hedges that might otherwise need to be discontinued due to uncertainties arising from IBOR reform.

The IASB is aware that, without the reliefs, some hedges might fail to qualify for hedge accounting in the near future. It is therefore aiming to finalise the amendments in late 2019: to facilitate this, the Exposure Draft had a shorter than normal comment period, ending on 17 June 2019.

More specifically, the Exposure Draft proposes that:

- the 'highly probable' requirement should be amended such that, when assessing the likelihood that a forecast transaction will occur, an entity would assume that IBOR-based contractual terms are not altered as a result of IBOR reform
- the prospective hedge effectiveness assessment should be amended such that an entity would assume that the IBOR-based contractual cash flows from the hedging instrument and the hedged item are not altered as a result of IBOR reform, and

- an entity would continue hedge accounting where a non-contractually specified IBOR risk component met the separately identifiable requirement at the inception of the hedging relationship, even if it does not meet that requirement at a later date.

The proposed amendments will have an impact in all jurisdictions that have decided there is a need for IBOR reform. They will affect companies in all industries that have applied hedge accounting for IBOR-related hedges, such as hedges of loans, bonds and borrowings with instruments such as interest rate swaps, interest rate options, forward rate agreements and cross-currency swaps.

Some of the feedback on the ED has included:

- the need to ensure that all affected hedge designations are included within the scope of the relief (eg. cross-currency swaps hedging foreign exchange risk, and not interest rate risk), and
- concerns about the lack of relief for retrospective assessments of effectiveness (the 80%-125% test) for those entities (primarily banks) that continue to apply IAS 39. Here the concern is that a hedge relationship may fail solely because of the uncertainties arising from IBOR reform.

What's next?

In addition to the above points relating to Phase 1 of the IASB's project, many commentators have requested the IASB accelerate its consideration of the Phase 2 issues. In many cases, markets have already started to move towards implementing the new rates. In Australia, this was marked by the South Australian government recently issuing an AONIA linked bond[2]. Regulators are also encouraging credit providers to start a dialogue with their customers. The best conversations will be the ones where both parties are informed by the results of their commercial and operational impacts assessments. Companies are seeking clarity around how to account for changes in the rate being referenced, changes in the credit spread, and any resulting value transfers.

What do you need to do?

Changes to interest rate benchmarks, including BBSW, are already in progress. We've touched on some of the financial reporting impacts of the changes, but given how embedded interest rate benchmarks are in the financial system, there are many others to consider. These include operational, legal, tax, compliance, risk management and governance. Companies need to understand the extent of the impact on their organisations so they can act to reduce risk and unnecessary costs.

[2] S Thompson and A Macdonald, South Australia scraps BBSW for $500m bond deal, *Australian Financial Review*, 6 June 2019. Accessed 24 June 2019.