In depth
A look at current financial reporting issues

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What's inside:

Financial reporting impacts from replacement of LIBOR and other interbank offered rates

At a glance

Following the financial crisis, the replacement of benchmark interest rates such as LIBOR and other interbank offered rates ('IBORs') has become a priority for global regulators. Many uncertainties remain but the roadmap to replacement is becoming clearer. Given the pervasive nature of IBOR-based contracts amongst financial institutions and corporates alike, this publication highlights the potential impacts of these changes on financial reporting under IFRS. This is based on current thinking but the IASB has also added the matter to its agenda. Key areas of immediate focus include hedge accounting and disclosure, with longer-term considerations focused on how to account for replacement of IBORs when the changes take effect. The Appendix highlights line items in financial statements that might be directly or indirectly impacted by the replacement of IBORs. More broadly, the implications of IBOR replacement are far-reaching, and consideration will need to be given to a wide range of commercial impacts, including contract amendments and fair value measurement.

Background

Benchmark interest rates are a core component of global financial markets. Retail and commercial loans, corporate debt, derivatives markets and many other financial markets all rely on these benchmark interest rates for the pricing and hedging of interest rates and other risks. The London Interbank Offered Rate ('LIBOR') is one of the most common series of benchmark interest rates, referenced by contracts measured in the trillions of dollars across global currencies. Following the financial crisis, calls grew to reform the process used to price LIBOR (including USD LIBOR, JPY LIBOR, CHF LIBOR and GBP LIBOR), other IBORs such as Euribor, and other benchmark interest rates. This culminated in the UK Financial Conduct Authority ('FCA') decision to no longer compel panel banks to participate in the LIBOR submission process after the end of 2021 and to cease oversight of these benchmark interest rates.

There remains significant uncertainty around the timing and precise nature of these changes. However, it is currently expected that SONIA (Sterling Overnight Index Average) will replace GBP LIBOR, and that SOFR (Secured Overnight Finance Rate) will replace USD LIBOR; although, for some other rates (such as Euribor), the position is less clear.

Who might IBOR replacement affect and how?

Given the pervasive nature of IBOR-based contracts, entities will be affected in all sectors. These range from corporate entities with IBOR-based debt funding, or that have hedged debt (fixed or floating) with derivatives that reference an IBOR, to financial institutions such as banks and insurers. Even if an entity does not have any contracts referencing an IBOR, it might still use an IBOR in constructing discount rates for use in financial reporting, such as in calculating an asset's 'value in use' when assessing it for impairment, and so it might still be affected by these changes. Major global banks are likely to be most affected by IBOR replacement, given the significant extent of their direct exposure to IBOR-linked financial instruments.

The nature of the impacts of IBOR replacement is potentially wide-ranging, including risk, management, legal, IT and financial reporting. This publication focuses on the potential financial reporting impacts under International Financial Reporting Standards ('IFRS'), based on current thinking. However, there are many aspects of IBOR replacement that remain unclear, so it is inevitable that thinking will continue to develop. For publications on the latest developments in IBOR replacement, and for further reading on other aspects of IBOR replacement, visit our LIBOR reference rate and reform insights page.

What are key considerations for 2018 financial reporting?

Cash flow hedges and the 'highly probable' test

Cash flow hedge accounting under both IAS 39 and IFRS 9 requires future hedged cash flows to be 'highly probable'. Where these cash flows depend on an IBOR (for example, future LIBOR-based interest payments on issued debt hedged via an interest rate swap), the question arises as to whether, at 2018 year ends, the issued debt's cash flows can be considered 'highly probable' beyond the date at which the relevant IBOR is expected to cease being published.

We consider that cash flows can still be considered 'highly probable' for 2018 year ends, for a number of reasons. Firstly, unless there are any clauses that would cause the hedged item to terminate on LIBOR ceasing, it will still contractually have floating rate cash flows once LIBOR has been replaced. Secondly, when replacement happens, with, for example, the hedged debt moving from paying GBP LIBOR + X% to paying SONIA +Y%, the expectation is that Y will be set so as to minimise value transfer for both parties and result in the cash flows being broadly equivalent before and after the change. As a result, until Y is defined, the changes in the cash flows post-replacement are driven by LIBOR. Thirdly, given the limited liquidity for replacement rates at the current time, the best predictor of the replacement rate in the future is the current equivalent LIBOR rate.

Given that net investment hedges are accounted for in a similar way to cash flow hedges, these considerations would also apply to net investment hedges where relevant.

Hedges where the designated hedged risk is in terms of an IBOR

For similar reasons, where the hedged risk has been designated in terms of an IBOR (in either a cash flow or fair value hedge), it can be judged that, in the context of the market structure as it stands at the end of 2018, the IBOR remains a hedgeable risk component. This is further supported by the fact that, at the end of 2018, fixed-rate instruments continue to vary in price directly in response to changes in the IBOR, even if they have maturities significantly beyond the IBOR replacement date.

Disclosures

Appropriate disclosure of the impending replacement of LIBOR and associated considerations should be provided in the 2018 annual report. Local reporting regulations might require companies to disclose this information as part of the risks and uncertainties facing a company, for example, in the 'front half' of the annual report or in management's discussion and analysis ('MD&A').

What are longer-term financial reporting considerations?

Beyond 2018 year-end reporting, multiple balance sheet line items might be impacted by IBOR replacement, either directly or indirectly. Some of the key items are discussed below, together with perspectives on current thinking. Whilst the IASB has put IBOR replacement on its agenda, it is not yet clear whether it will propose any standard-setting activity. However, where similar issues have arisen in the past and the IASB has decided to amend standards, it has acted on a timely basis. For example, when derivatives were novated to central clearing counterparties, IAS 39 and IFRS 9 were amended to avoid the potential need to terminate hedge relationships.

The Appendix contains balance sheet extracts of typical line items of financial and non-financial services entities that might be directly or indirectly impacted by IBOR replacement. Whilst not an exhaustive list, some of the key areas directly and indirectly impacted are also discussed below.

Changes to contracts for cash instruments, such as variable-rate loans and bonds

The consensus appears to be that the most appropriate way to account for a change in the reference variable rate due to IBOR replacement, in a cash instrument such as a loan or bond, would be by simply updating the variable interest rate used to calculate the effective interest rate and hence the reported interest income or expense. [IFRS 9 para B5.4.5]. This normally has little or no impact on the carrying amount of the asset or liability.

However, given the new guidance introduced in IFRS 9, if the terms of the loan or bond are amended to provide for the replacement, particularly where other changes to terms are made at the same time, recognition of an immediate gain or loss on modification might be an alternative approach. [IFRS 9 para 5.4.3]. This would require discounting of future cash flows using an IBOR-based effective interest rate, which might no longer be published at that point in time. Another possible accounting outcome could be that the change is considered to be a substantial modification, resulting in derecognition of the original financial instrument and recognition of a new instrument for accounting purposes. [IFRS 9 para 3.2.3]. However, this last outcome would seem unlikely if IBOR replacement results in minimal change.

Hedge accounting documentation

The accounting considerations for hedges depend on how the hedge relationship is currently documented, which risk is being hedged, and what (if any) changes are required to the hedged item, hedged risk and/or hedging derivative when benchmark rates are changed. Normally, a change in hedge documentation requires the hedge relationship to be discontinued. Even where a new hedge relationship is designated, this typically gives rise to hedge ineffectiveness in a cash flow hedge. However, there is ongoing debate and many have a strong view that a market-wide change of this nature should not cause a pervasive termination of hedge relationships. This might be an area that the IASB will consider addressing as part of its project on IBOR reforms.

Hedge effectiveness and ineffectiveness (for cash flow and fair value hedges)

Prospective hedge effectiveness testing under IAS 39 typically considers whether there is expected to be a high correlation between the fair value or cash flows of the hedging instrument and the hedged item. As discussed under ‘Cash flow hedges and the “highly probable” test’ above, cash flows under IBOR and IBOR replacement rates are currently expected to be broadly equivalent before and after IBOR replacement, which should minimise any ineffectiveness. However, if the market valuation of the hedging instrument starts changing in anticipation of a move to the IBOR replacement rate sooner than the hedged item (that is, the derivative valuation is no longer simply based on its current contractual terms), or vice versa, then even where the hedged risk is deemed to still exist, differences in fair values between the hedging instrument and the hedged item would give rise to ineffectiveness in the prospective assessment, as well as in the retrospective effectiveness assessment.

Under IFRS 9, these factors would also need to be taken into consideration in assessing the criteria for a hedge to qualify for hedge accounting at inception and on an ongoing basis, in particular whether there is an economic relationship between the hedging instrument and the hedged item and that the hedge ratio remains valid.

In addition, if the benchmark rate replacement occurs at different times in the hedged item and the hedging instrument, the resulting mismatch might give rise to hedge ineffectiveness to be recorded in the income statement under both IAS 39 and IFRS 9. Further complications and ineffectiveness might arise if there are timing or other differences between market pricing, changes to contracts and changes to hedge documentation.

Instruments measured at fair value

Fair value measurement could be impacted both where the contractual terms of an instrument are expected to change to reflect an IBOR replacement rate, and where IBOR-based discount rates are used as an input to fair value methodologies. IFRS 13 provides the accounting requirements for fair value measurement, which are driven by the underlying principle to consider factors that other market participants would take into consideration when fair valuing an instrument.

If market participants start to value contracts using the IBOR replacement rate, even before contracts have actually been amended in anticipation of the move, that methodology change would need to be reflected in accounting fair values. Similarly, market discount rate methodologies might also change in advance of actual IBOR replacement. Therefore, it is not necessarily the case that fair value measurement methodologies need only be updated once IBOR-based rates have actually been replaced in contracts. However, judgement might well be needed to determine when such changes happen, as has been seen in the past – for example, when certain markets moved towards discounting collateralised derivatives using the Overnight Index Swap rate (rather than using LIBOR) over a period of time, rather than at a single point in time.

Related to this, system and process changes might well be required, to develop new discount rate curves under the IBOR replacement rates and to update related controls over valuations.

Lease liabilities with variable payments linked to an IBOR

For any variable lease payments which are linked to an IBOR, IFRS 16 requires the discount rate and the lease liability to be updated when the cash flows change (that is, when the IBOR-based rate is updated, similar to a floating-rate loan).

Assets and liabilities impacted indirectly

As highlighted in the Appendix, several balance sheet line items might be indirectly impacted by IBOR replacement if they use an IBOR-based discount rate. Therefore, whilst accounting standards might not explicitly mention IBOR, entities should understand what impact, if any, IBOR replacement might have on their future calculations, particularly if there is a significant sensitivity to the discount rate.

Particular areas that might be affected include IAS 37 provisions, insurance assets and liabilities under IFRS 4 and IFRS 17, contract assets arising from revenue contracts with customers under IFRS 15, pension liabilities under IAS 19, as well as value-in-use models for assessing non-financial asset impairment under IAS 36.

For lease liabilities under IFRS 16 using an incremental borrowing rate, IBOR replacement is not expected to have an impact on existing lease liabilities. This is because the incremental borrowing rate is fixed at the inception of the lease, and that rate is applied to the lease liability over the whole lease term to measure the lease liability at its effective interest rate. New leases entered into following IBOR replacement will then have incremental borrowing rates determined using a benchmark rate based on the IBOR replacement rate.

What should I be doing now?

Entities will need to develop a plan for IBOR replacement. Given the potentially large volume of contracts that might need to be amended, and other related impacts on systems and processes, entities are advised to develop a robust plan well ahead of when the replacement occurs.

Financial reporting teams will need to stay close to these broader organisational responses, to understand any planned changes and to assess the financial reporting implications. Key steps to ensure robust ongoing financial reporting are likely to include:

- Plan disclosures to be included in 2018 year-end financial reporting, taking account of current internal plans.
- Assess changes needed to existing hedge accounting relationships and potential accounting consequences.
- Consider the accounting consequences before changes are made to contracts in anticipation of IBOR replacement, to ensure that they are as intended and that accounting systems and processes will actually implement this accounting.
- Understand any planned changes to contracts that go beyond those required by IBOR replacement alone (for example, if an instrument will also be repriced for changes in other factors since inception, such as credit risk), because these might introduce additional accounting considerations not discussed above.
- Monitor the activities of the IASB and incorporate into planned actions as appropriate.

Appendix: Balance sheet line items that might be directly or indirectly impacted by IBOR replacement

Directly impacted line items

Line items which might be directly impacted by IBOR replacement are those whose cash flows and/or carrying values might depend directly on IBORs:

Assets	Cash and cash equivalents
	Loans and other receivables
	Trading financial assets
	Financial assets designated at fair value
	Hedging derivatives
	Investment securities
Liabilities	Deposits and other payables
	Trading financial liabilities
	Financial liabilities designated at fair value
	Hedging derivatives
	Lease liabilities (with variable lease payments linked to an IBOR) (IFRS 16)
	Borrowings
Equity	Cash flow hedge reserve

Indirectly impacted line items

Line items which might be indirectly impacted by IBOR replacement are those for which the discount rate applied to their cash flows and/or carrying value might use IBOR-based rates as the benchmark rate:

Assets	Property, plant and equipment (IAS 36 impairment assessment)
	Right-of-use assets (IAS 36 impairment assessment)
	Intangible assets (IAS 36 impairment assessment)
	Defined benefit plan surplus (IAS 19)
	Contract assets from revenue contracts with customers (IFRS 15)
	Reinsurance assets (IFRS 4 and IFRS 17)
Liabilities	Provisions (accounted for under IAS 37)
	Lease liabilities (IFRS 16)
	Defined contribution and defined benefit plan obligations (IAS 19)
	Insurance liabilities (such as insurance contract liabilities and investment contract liabilities with discretionary participation features) (IFRS 4 and IFRS 17)

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner.

Authored by:

Sandra Thompson
Partner – Global IFRS Leader, Financial Instruments
Email: sandra.j.thompson@pwc.com

Jessica Taurae
Partner – UK IFRS Leader, Financial Instruments
Email: jessica.taurae@pwc.com

Mark Randall
Director – UK Banking Lead and IFRS Specialist, Financial Instruments
Email: mark.b.randall@pwc.com

Louise Brown
Senior Manager – UK IFRS Specialist, Financial Instruments
Email: louise.brown@pwc.com

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