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Corporate Treasury Insights

IBOR Transition – Treasury considerations

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The future of IBOR – Are you Ready?

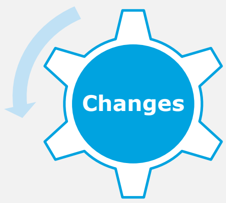
Time to take action

In July 2017, the UK Financial Conduct Authority (FCA) **announced a transition away from the Interbank Offered Rate (IBOR)** as the key interest rate index used in calculating the interest rate for loans, bonds, derivatives and other financial contracts. The FCA's intention is that, at the end of 2021, it would no longer be necessary to persuade, or compel, banks to submit to IBOR.

We set out below an overview of the key changes and explore some of the key questions that many corporate treasurers are asking in relation to the transition. It is important to understand the potential impacts, and practical considerations, of the transition.

What is changing?

IBOR underpins approximately $300 trillion in financial products and is one of the most significant reference rates used by financial market participants. Work is underway in multiple currency jurisdictions to identify and transition to alternative nearly risk-free rates (RFRs). The working group for the UK is the Sterling RFR Group. They have recommended that GBP IBOR should be replaced by the Sterling Overnight Index Average, (SONIA).



We set out below a summary of the progress made to date by the different working groups.

Jurisdiction	Alternative risk free rate	Rate administrator	Key features
UK	Reformed Sterling Overnight Index Average (SONIA)	Bank Of England	• Fully transaction-based rate, based on a functioning underlying market. • Overnight, risk-free reference rate. • Includes an expanded scope of transactions to incorporate overnight unsecured transactions negotiated bilaterally and those arranged with brokers. • Includes a volume-weighted trimmed mean.
US	Secured Overnight Financing Rate (SOFR)	Federal Reserve Bank of New York	• Fully transaction-based rate, based on a functioning underlying market. • Overnight, risk-free reference rate that correlates closely with other money market rates. • Covers multiple repo market segments, allowing for future market evolution.
Europe	To be determined	To be confirmed	• The Working Group on Risk-Free Reference Rates for the Euro Area has not selected an alternative RFR. A new unsecured overnight interest rate could be among the possible alternatives.
Switzerland	Swiss Average Rate Overnight (SARON)	SIX Swiss Exchange	• Became the reference interbank overnight repo on 25 August 2009. • Secured rate that reflects interest paid on interbank overnight repo.
Japan	Tokyo Overnight Average Rate (TONA)	Bank of Japan	• Fully transaction-based benchmark for the functioning uncollateralized overnight call rate market. • The Bank of Japan calculates and publishes the rate on a daily basis, using information provided by money market brokers (Tanshi). • An average, weighted by the volume of transactions corresponding to the rate.

The pricing of many financial instruments is tied to IBOR. Therefore the replacement of IBOR with an alternative RFR may impact a range of derivatives, debt and investment instruments and other contracts and require the re-papering of multiple documents. Such changes will have significant implications for corporates.

Derivatives

- Interest rate and inflation linked swaps
- Cross currency swaps
- Credit default swaps
- Interest rate options/ floors (OTC & ETD)
- Swaptions
- FX forwards

Debt and investment instruments

- Bank current accounts and deposits
- Commercial paper (CP)
- Money markets
- Issued, term and syndicated loans
- Intercompany loans
- Letters of credit
- Trade finance
- Securitised lending

Other contracts

- Leases
- Rates of return on investments
- Commercial e.g. price adjustment mechanisms or penalties on late payments may incur interest
- Discount rates for valuation purposes
- Regulatory models

Preparing for transition

The transition from IBOR is a few years away, however it is expected to have a major impact on financial instrument markets. It is important to use this time to identify the impact for your organisation now and put in place an IBOR transition plan. We have set out below an overview of the key activities and considerations firms should take in the transition from IBOR:

Measuring IBOR exposure

Undertake an impact assessment of the current exposure to IBOR to identify the exposure quantum, raise awareness of the transition impact and prioritise practical next steps.

- Include all external and internal borrowing and funding commitments, derivatives, cash pooling, leases and other contracts or models that reference IBOR, assessing the spreads and maturities.

Re-papering/Re-contracting

Review documentation to identify any fall back provisions or any contractual terms that may provide for transition.

- Engage early in understanding the potential impact on contracts and plan accordingly changes to existing contracts. It is important to include any intercompany arrangements in this assessment.
- Future-proof new contracts by considering the wording of any contracts entered into. Prepare fall back provisions in all new contracts referencing IBOR e.g. lenders may be willing to include language that states a new replacement index will be agreed by the borrower and lender.

Economics

Understand the impact the new RFR will have on the contract terms in order to assess the changes to contract cashflows and the impact on hedging strategies and key reporting metrics.

- Consider whether the replacement RFR requires a change in funding or hedging strategies e.g. the pricing structure for cross-currency swaps may change given the two legs may be priced using different RFR structures.
- The new RFR may not be consistently adopted across all types of financial contracts and therefore an economic mismatch could arise between a derivative and the underlying hedged exposure.

Financial reporting

Understand the impact that the new RFR will have on financial reporting.

- The financial reporting considerations include but are not limited to: de-recognition considerations, potential changes to the carrying amount of the debt instrument and the fair value of derivative instruments and the application of hedge accounting.

Systems, processes and controls

The transition may necessitate changes to a swathe of internal systems, processes and controls.

- Identify all processes, systems and controls impacted by the change e.g. systems may need to be updated with the new RFR curves for trade execution, capture, settlement, valuation and hedge accounting. This will have implications for the associated processes and controls and may introduce new risks.
- Any internal models that use IBOR as an assumption will also need to be updated for the replacement RFR.

What are the key financial reporting challenges arising from the proposed transition?

Considerable uncertainty remains as to how the replacement of IBOR with a new RFR will be orchestrated, therefore, treasurers will need to prepare for a wide spectrum of outcomes. IBOR transition is expected to generate a range of accounting considerations for corporates that has the **potential to impact reported numbers** including key measures such as net interest, net debt and fair value gains and losses. We set out below some of the key financial reporting considerations for treasurers in preparing for the withdrawal of IBOR.

Debt contracts

Are the enforced revised contractual terms that reference the new RFR substantially the same as the previous terms referencing IBOR?

Treasurers will need to assess the impact of the amended changes, giving consideration to both quantitative and qualitative features. Concluding they are not substantially the same could trigger de-recognition/re-recognition.

Derivative fair value

How will the enforced revised contractual terms impact the fair value of derivatives?

- The replacement of IBOR by a new RFR will give rise to a change in the underlying cash flows and could impact the fair value of the derivative. Additionally, the discount factor used in the determination of fair value will change. It will be necessary to assess how any difference in fair value will be accounted for at transition. This could result in an immediate and ongoing P&L impact.
- Where there is a difference in cash flows, it leads to the question of compensation cash flows and the basis upon which any compensation should be calculated. Additionally, a corporate may wish to restructure existing derivative contracts as a result of revising risk management strategies. This will have additional accounting and fair value implications.
- Cross currency basis swap quotes are typically for float-float instruments. Where GBP is one of the currencies, the floating rate is usually 3-months GBP IBOR. If IBOR disappears, new GBP/non-GBP cross-currency contracts will need to start to be traded. Valuation systems will need to be able to cope with these new instruments, not only in terms of being able to book these trades, but also to include them as part of bootstrapping routines to calculate basis-adjusted discount curves e.g. discounting a GBP swap with a EUR cash CSA.

Hedge accounting

The ability to continue existing hedge relationships will depend on various factors, even in the case where de-recognition of the hedging instrument is avoided. We set out some key questions that corporates are asking below:

Will the change from IBOR to the new RFR require de-designation and re-designation of the existing hedge relationship?

This will depend on whether the change from IBOR to the new RFR is viewed as a change in the hedged risk and whether any guidance is issued by the International Accounting Standards Board (IASB).

Will existing cash flow hedges of highly probable forecast exposures linked to IBOR be considered highly probable today?

Given it is known that the debt benchmark interest rate will change after 2021, can the hedged item in existing hedge relationships continue to be treated as highly probable today? Similar to the above, this will depend on whether the change from IBOR to the new RFR is viewed as a change in the hedged risk and whether any guidance is issued by the IASB.

Will any ineffectiveness arise?

If, following transition, the terms of the underlying hedged item and the corresponding hedging instrument are not the same, ineffectiveness will likely arise. It is not yet clear whether there will be a change in the term structure of the designated risk, e.g. from 3-months to overnight.

Liquidity in the new RFR may not be as deep, meaning that testing performed using regression analysis may not have a sufficient number of data points. Additionally, as transition approaches, IBOR curves may become less liquid, which may affect the prospective hedge effectiveness of the hedge.

Need to know more?

If you require any further information on any of the issues mentioned in this material and on how Deloitte can help you address the challenges ahead, please do not hesitate to contact:

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