IBOR transition – practical experiences and lessons learned
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By John Kent and Alev Halit Ongen

As 2021 passed into history, so did certain familiar Interbank Offered Rates (IBORs). Banks and corporations have been hard at work with their transition projects—some, such as the Sterling markets within the UK are largely complete, while other markets still have some way to go. From an IFRS accounting point of view, the well documented reliefs (provided in two phases by the IASB) have stood up well and assisted in a smooth transition avoiding accounting disruption and volatility. Hedge accounting generally continued unscathed and swathes of spreadsheets calculating modification gains/losses on debt and complex hedge ineffectiveness were not needed. What might have been IFRS armageddon was, in the event, an IFRS Y2K—thanks to well-designed IASB reliefs and a lot of hard work by organizations' finance teams, market participants, and audit and assurance providers.

In this article we do not seek to repeat the details of the IASB phase 1 and 2 reliefs – they have been comprehensively covered elsewhere. Rather we take a look back at some of those practical issues that arose during transition projects and highlight some of the lessons learned so far. As IBORs continue to be retired in coming months and years, more issues may arise.

Stubborn systems stuck in their ways

One of the many issues highlighted by IBOR reform are the concerns presented by antiquated operating systems that lack the flexibility to deal with market solutions to transition. For example, a common and elegant swap conversion mechanism is the mirror swap package approach (the so called "*close-out and replace on the same terms (i.e., off-market terms)"* approach). This entails the existing swap counterparty providing a pair of new swaps that align with the terms of the original in-play IBOR based interest rate swap—one is IBOR based that mirrors and offsets the original, and the other that is new risk-free rate (RFR) based. Taken as a package, the process neatly converts the reference rate from IBOR to RFR and tees up the offsetting IBOR swaps for future compression. No controversial accounting issues arose as the mechanism was given the green light by phase 2 of the IASB's amendments to IFRS at IFRS 9:BC6.620(a) / IAS 39:BC312(a). Technical accounting is only part of the story—outdated systems need persuading to play ball. An issue that preparers have faced is an inability of some legacy systems to cope with day 1 fair values of other than zero for the new swaps. Because the swap package terms match the original swap and are therefore off-market, they have a fair value of other than zero and match the current fair value of the original swap. So, the mirror IBOR swaps are net economically flat and leave the day 1 fair value of the new RFR swap. Some systems by default insist on treating this day 1 fair value as a form of fee (like an option premium) and try to prospectively amortize it to profit or loss sometimes on a straight-line basis—when in accounting terms it represents nothing more than the opening fair value of the hedging instrument. As a result, if such system eccentricities are not identified and intercepted, the result can be unexpected false ineffectiveness volatility in ongoing hedge relationships. Successful navigation of systems and communication is all part of the IBOR transition story.

Uncertainty over the end of uncertainty

In certain jurisdictions, much of the emphasis during 2021 has been on the conversion process and the application of the IASB's phase 2 amendments. However, phase 1 amendments are not necessarily over. For example, consequential amendments made to IFRS 7 by phase 1 require disclosures concerning *uncertainty* arising from interest rate reform. One of those IFRS 7 requirements calls for *"a description of significant assumptions or judgements the entity made in applying these paragraphs* [phase 1 hedging reliefs] *(for example, assumptions or judgements about when the uncertainty arising from interest rate benchmark reform is no longer present…*)". This raises the question as to when the 'uncertainties' addressed by phase 1 are no longer present. And that is uncertain.

For example, determination of ISDA fixed basis spreads applied to certain RFRs was announced ahead of those IBORs being withdrawn at the end of 2021 and in advance of contracts formally transitioning. So, when was the uncertainty surrounding those instruments resolved to drop out of the scope of phase 1 disclosures? Elsewhere on the uncertainty spectrum are those awkward IBOR legacy contracts that have proved just too troublesome to amend and for which synthetic LIBOR will continue to be published. When will these be resolved? And what about other instruments not within the scope of ISDA for which there remains bilateral negotiation to be undertaken? Or where the parties negotiate to override the terms of particular fall-back language? Given these questions, the timing of when the phase 1 amendments to IFRS 7 no longer apply needs a clear understanding of the facts and circumstances.

Did the rates desks and treasury groups get the memo?

One risk that kept some finance and accounting policy teams awake at night was that hedging instruments could get converted in such a way that precluded application of the phase 2 reliefs. Rates teams or treasury teams could find themselves tempted by potentially new third party swap counterparties seeking to grow their business by accepting novations of IBOR swaps and offering mirror swap packages to convert IBOR swaps currently provided or cleared by other counterparties. A commercially tempting deal may make perfect economic sense for the business. But executing could prove damaging to formal IFRS hedge accounting that uses the legacy swap as an IFRS hedging instrument—the arrangement brings about change of counterparty. In this regard, phase 2 IFRS 9:BC6.620(d) / IAS 39:BC312(d) contains the warning that the novation of a swap to a new counterparty constitutes the de-recognition of the hedging instrument and termination of hedging. Sometimes the most attractive commercial route brings an accounting cost with it. This issue highlights the importance of a robust governance that engages stakeholders and participants across the organization. This is key in ensuring transition projects proceed smoothly and without unpleasant IFRS surprises.

A price of operational elegance?

While the phase 2 amendments have been very well received, they cannot cater for all circumstances and as such a role for judgment and interpretation will continue. This is particularly true for the ongoing emergence of market led proposals designed to optimize the end-to-end efficiency of IBOR reform which sometimes present interpretive challenges for the accounting rules.

Buy now, pay later?

Proposals of some clearing houses provided that the adjustments to swap basis spread arising from converting from (say) LIBOR to SONIA be cash settled upfront rather than built into the future spread of the replacement RFR swap. One attraction of this approach is that it increases the generic nature of the SONIA swap thereby easing the way to future compression or other transactions involving the swap population. However, while some might say what is the difference between cash settling the spread adjustment now or over time, the phase 2 amendments did not anticipate this development. Indeed, some accountants point to IFRS 9:BC6.620(b) / IAS 39:BC312(b) that describe closing out the current swap with a cash settlement and entering into a new swap at market terms. Analogizing to those BC paragraphs may suggest this approach does not qualify for the phase 2 reliefs. Others may argue that BC6.620(b) / BC312(b) are dealing with a different scenario as the scenario described here is not cash settling the *entire* derivative. As such a cash settlement that represents only a small part of the derivative may still be capable of being considered 'economically equivalent' for the purposes of the phase 2 relief. Interpretation continues to evolve and serves as a reminder that the IFRS amendments published by the IASB are not a panacea for every transition eventuality.

Overlaying

Another area of discussion relates to overlay swaps—again provided by certain clearing houses. In summary, these overlay swaps are designed to defer the effect of the clearing house conversion from IBOR to RFR where that conversion date occurs before the relevant IBOR's cessation date. This enables the reporting entity to maintain the original derivatives cash flow and risk profile for periods where IBOR is still representative (i.e., the period covered by the final fixing where that extends beyond the cessation date).

For example – a reporting entity has a pay IBOR, receive fixed interest rate swap expiring in 2025. The reference IBOR ends 31 December 2021. The IBOR is fixed three months in advance with the final fixing taking place on 20 December 2021. As such, the in-accrual period overlaps the cessation date.

In good operation timeliness, the clearing house converts all swaps referencing that IBOR to new RFR on 10 December 2021. Absent any other transactions the entity's swap converts to new RFR on this date. However, IBOR remains relevant for the three-month period from 20 December 2021 with final IBOR cash payment made on 20 March 2022. The clearing house therefore provides an 'overlay' swap arrangement—entity receives RFR, pay IBOR through to 20 March 2022 thereby, taken as a whole, deferring conversion until that date. As such the RFR becomes forward starting. In a further twist, the 'overlay' swap is comprised of two swaps—a receive RFR, pay fixed (0%), and a pay IBOR, receive fixed (0%) which helps maximize future compressibility against the swap population.

The presence of multiple swaps in this arrangement raises a 'unit of account' question. Arguably the entire arrangement has to be viewed for accounting purposes as a single unit of account to successfully conclude that the arrangement is nothing more than the conversion of the hedging instrument from IBOR to new RFR on 20 March 2022 with the preceding trades being nothing more than operational priming. Provided that view holds then the arrangement may qualify for 'economic equivalence' per the phase 2 amendments. However, viewing the swaps as separate instruments could disturb that view.

Looking back—and forward

IBOR transitions have been hard work requiring huge time commitment from all stakeholders. But they have been largely successful and the IASB amendments have stood up well. Practical issues inevitably arose, and we hope by sharing this selection that ongoing and future transition projects can be smoother still.

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If you would like to discuss further, please contact:

John Kent
Deloitte Global Accounting and Reporting Advisory Leader
Deloitte China
jkent@deloitte.com.hk
John Kent | LinkedIn

Alev Halit Ongen
Senior Manager, Accounting Advisory
Deloitte LLP, London
ahalitongen@deloitte.co.uk
Alev Halit Ongen | LinkedIn