STAFF PAPER

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Project	**IBOR reform and the effects on financial reporting**
Paper topic	Research project proposal

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Introduction

1. Interest rate benchmarks (such as LIBOR, EURIBOR and TIBOR) play a key role in the global financial markets. These benchmarks index trillions of dollars in a wide variety of financial products, from derivatives to residential mortgages.

2. Recent market developments have brought into question the long-term viability of such benchmarks. In some jurisdictions, there is already a clear steer towards replacing them by alternative, nearly risk-free rates, which are based to a higher extent on transaction data.

3. The possible discontinuation of interest rate benchmarks could have a significant and widespread impact across financial markets, as well as in other areas where such benchmarks are used. Not surprisingly, there is also increasing interest by stakeholders in potential effects on financial reporting.

4. The objective of this paper is to set out the background of such recent developments, and to propose that the Board add a research project to its research agenda. The objective of such a project would be to monitor further developments in this regard and determine whether there are any implications for the existing accounting requirements.

Structure

5. This paper is organised as follows:

    (a) Background information;

    (b) Research project proposal; and

    (c) Staff recommendation.

Background information

What are the IBORs?

6. IBORs are interest reference rates that represent the cost of obtaining unsecured funding, in a particular combination of currency and maturity, and in a particular interbank term lending market. The most widely used of these reference rates is the London Interbank Offered Rate (LIBOR). Other examples of IBORs are the Euro Interbank Offered Rate (EURIBOR) and the Tokyo Interbank Offered Rate (TIBOR).

7. IBORs are generally calculated on the basis of submissions of participating panel banks, which are asked at what rates they could borrow money in a specific interbank market on an unsecured basis. These submissions may require the use of expert judgement for markets that are not sufficiently active.

8. IBORs are used extensively in the global financial markets by a variety of market participants and in a number of different financial products. They are used to specify the contractual cash flows for a wide range of credit products—such as loans, structured products and bonds— as well as derivatives such as swaps, options and forwards. The total estimated notional outstanding amount of contracts indexed to IBORs is over US$300 trillion. The greater part of this total notional amount arises from derivatives, but there are also large exposures from credit products. [1]

[1] For further discussion, see section III ‘The Role of Reference Interest Rate’ in FSB ‘Reforming Major Interest Rate Benchmarks’ report issued in July 2014 (FSB Report). The report is available at http://www.fsb.org/2014/07/r_140722/.

Reference rate reform

9. Recent developments have highlighted the need to reform such benchmarks. In particular, following the global financial crisis, the continued decrease in the volume of eligible transactions in the markets that these benchmarks measure[2] suggested they might not continue to be fit for purpose in the long run.

10. In this context, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest benchmarks and develop plans for reform to ensure that these benchmarks are robust and appropriately used by market participants. The approach to the reform supported by the FSB, published in a report in July 2014, had two main elements:

    (a) strengthening existing major interest rate benchmarks by underpinning them to the greatest extent possible with transaction data; and

    (b) developing new alternative reference rates that are nearly risk-free (RFRs).

11. This approach, also referred to as the ‘multiple-rate approach’, presented a number of benefits, among which were minimising market disruption and costs of transitioning existing legacy contracts, and offering an alternative reference rate that is closer to risk-free and best suited for some financial transactions (in particular for many derivatives). It also reduces the reliance on a single, dominant reference rate.

12. Since the issue of that report, there has been continued progress towards the strengthening of major interest rate benchmarks, as well as in identifying potential RFRs. In some jurisdictions, alternative RFRs have recently started to be published. This is the case, for example, for the Secure Overnight Funding Rate (SOFR) in the US, and the reformed Sterling Overnight Index Average (SONIA) in the UK. In its last progress report, however, the FSB highlighted questions

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[2] For further discussion, see section IV-B ‘Framework for Change – Implications’ in the FSB Report.

arising in some jurisdictions about the feasibility of sustaining some IBORs in the long term.[3]

Preparing for transitioning away from IBOR

13. Although it is still uncertain what the future of each IBOR will be, some market participants, regulators and industry bodies (stakeholders) have already started to consider the potential impacts of a scenario where the benchmarks are no longer available.

14. A transition away from IBOR presents numerous challenges which will need to be dealt with by stakeholders, such as:

    (a) amending legacy contracts to replace an IBOR by its respective RFR.

    (b) dealing with the pricing gap between IBOR (which includes bank credit risk) and the respective RFR, which are nearly risk-free.

    (c) many of the RFRs reflect the rate of overnight transactions and currently lack the term structure offered by IBORs, which are produced for multiple maturity periods.

15. In addition to the challenges discussed in the paragraphs above—and also as a consequence of them—stakeholders are starting to consider what are the effects to financial reporting of a potential discontinuation of the IBORs. As a result of this, some questions are arising in relation to accounting for financial instruments. Questions may also arise in other areas of accounting.

Research project proposal

16. Paragraph 4.7 of the *Due Process Handbook* explains that the purpose of the research programme is ‘to analyse possible financial reporting problems by collecting evidence on the nature and extent of the perceived shortcoming and

[3] The FSB have been documenting the progress against its recommendations across jurisdictions in annual progress reports. The last of these reports, issued in October 2017, can be found at http://www.fsb.org/2017/10/reforming-major-interest-rate-benchmarks-4/.

assessing potential ways to improve financial reporting or to remedy a deficiency.'

17. Paragraph 4.8 states that 'to help the IASB in developing its work programme, technical staff are asked to identify, review and raise issues that might warrant the IASB's attention.' The Board also stated, in its Feedback Statement on the 2015 Agenda Consultation, that 'if circumstances change—for example if significant new issues emerge—the Board may need to add other research projects to its active research programme or research pipeline'.

18. As discussed in the background section of this paper, the potential discontinuation of IBORs could have a significant and widespread impact on financial markets. These benchmarks are embedded in a wide variety of financial instruments, which are held or issued by a vast number of IFRS reporters globally. The effects of such developments to financial reporting may be significant.

19. The IBOR reform, and the potential replacement of IBORs by selected RFRs, are long and complex processes. Market developments continue to unfold and there is still great uncertainty around the future of the IBORs. However, in some cases, stakeholders have already started working towards a transition to RFRs.

20. In our view, it is therefore important that the Board starts gathering evidence to be able to assess the nature and extent of the effects and determine whether the Board needs to take any actions on a timely basis. We note that, as it was the case in similar situations in the past that involved regulatory change, the Board may need to react rapidly to avoid potential undesirable effects on financial reporting.[4]

Research project plan

21. The proposed research project would comprise the following activities:

    (a) monitoring further developments of the IBORs reform and engaging with stakeholders to obtain an understanding of potential accounting implications; and

[4] See agenda paper 10 of the January 2013 Board meeting on 'Novation of derivatives and consequences for hedge accounting'.

(b) analyse evidence collected from the activities above and develop preliminary views on whether there are any implications for the existing accounting requirements and whether the Board would need to take any action.

22. We would expect to carry out the activities above over the next three to six months and then provide an update to the Board on our preliminary findings. However, given that market developments are still evolving, we may need to continue to monitor these developments after that period. Given the limited scope of the activities of the proposed research project, we do not anticipate concerns over resourcing.

Staff recommendation

23. For the reasons described in paragraphs 18-20, we recommend that a research project to assess the effects on financial reporting of the potential discontinuation of IBORs is added to the Board's active research agenda.

Questions for Board members
1) Do you agree with the Staff's recommendation to add to the Board's active research agenda a research project on the effects on financial reporting of a potential discontinuation of IBORs?