KPMG

2019 Update: Evolution of LIBOR Disclosures in Annual Reports

In an effort to monitor the London Interbank Offered Rate (LIBOR)[1] reform developments, we have been tracking how major US and international banks and corporates in various industries are preparing for the move to a new reference rate. Our most recent review of 2019 financial statement disclosures of large banks and other companies has revealed that the level of effort required to evaluate the impact of transition away from LIBOR is extensive and the impact to a company's financial statements is broad. We expect a company's disclosures to evolve through 2021, as regulators continue to provide additional guidance and expectations and companies make strides away from LIBOR.

LIBOR ranks among top risks SEC is monitoring

The expected discontinuation of LIBOR could have a significant impact on financial markets and may present a material risk for certain market participants. The US Securities and Exchange Commission (SEC) staff is actively monitoring the extent to which market participants are identifying and addressing financial statement impacts.[2]

The SEC Division of Corporate Finance encouraged companies to consider disclosing the following information on the impact of LIBOR to its business:

- Disclose the status of company efforts and any significant matters yet to be addressed
- Identify a material exposure and whether the expected impact can or cannot yet be reasonably estimated
- Information used by management and the board in assessing and monitoring the transition from LIBOR
- Notional value of contracts referencing LIBOR and extending past 2021.

While the Alternative Reference Rate Committee (ARRC) has identified the Secured Overnight Financing Rate (SOFR) as a potential alternative to LIBOR, the SEC issued its Examination Priorities in January 2020[3] noting that it will closely track and evaluate LIBOR reform. The SEC recommended that companies evaluate their exposure to LIBOR, both in the context of fallback language in contracts that allow for the succession of the next alternative reference rate and its use of benchmarks and indices across accounting systems and risk models.

The SEC staff underscored the importance of keeping investors informed about the progress toward risk identification and mitigation, any anticipated material impact on the company, and the use of both qualitative and quantitative disclosures for LIBOR reform, noting that "federal securities laws are designed in part to elicit disclosure of timely, comprehensive, and accurate information about risks and events that a reasonable investor would consider important to an investment decision."[4]

FASB provides relief to companies for reference rate reform

On March 12, 2020, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2020-04,[5] which provides relief for companies preparing for discontinuation of interest rates such as LIBOR. If an entity elects to apply the reliefs, they are required to disclose their nature and the reasons for applying them.

UK and European Regulators Monitoring Risks of Reform

The level of public disclosures by UK and European banks in light of LIBOR reform were driven by two key factors:

Existing IFRS disclosure requirements and LIBOR related amendments

Banks have followed IFRS 7 and IAS 1 requirements to disclose the nature and extent of risks, including financial instruments an entity is exposed to, changes to significant accounting policies, judgements management has made while applying those policies, and sources of estimation uncertainty. In addition, the International Accounting Standards Board (IASB®) provided amendments to IFRS 9, IAS 39 and IFRS 7 to assist in a smoother transition away from LIBOR. The amendments required the following information to be disclosed for hedging relationships impacted by LIBOR reform:

- The significant interest rate benchmarks to which hedging relationships are exposed
- The extent of risk exposure that is affected by LIBOR reform
- How the transition to alternative benchmark interest rates is being managed
- The nominal amount of the hedging instruments in those hedging relationships.

Level of local regulatory pressure and focus on transparency

In the UK, the Working Group on Sterling Risk Free Reference Rates (the UK equivalent to ARRC) has set a number of targets

[1] LIBOR is quoted for five currencies throughout the world. The use of LIBOR in this article refers to the USD LIBOR, GBP LIBOR, Euro LIBOR, CHF LIBOR and JPY LIBOR
[2] Source: SEC Staff Statement on LIBOR Transition, July 2019
[3] Source: SEC 2020 Examination Priorities, January 2020
[4] Source: SEC website, Speeches section, December 2018
[5] Source: ASU 2020-04, Reference Rate Reform (ASC 848)

over the next two years to drive market participants' transition away from GBP LIBOR to Sterling Overnight Interbank Average Rate (SONIA). The Working Group's targets have been emphatically supported by the UK financial services regulators, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), in letters to insurers, banks and asset managers. Regulators have made it clear that in 2020 they will be closely monitoring firms' progress in transitioning away from LIBOR.

In the Euro (EUR) market, unlike the GBP market, there are no specific reform target dates apart from the fact that the Euro OverNight Index Average (EONIA) will discontinue on January 3, 2022. However the EUR Working Group on Risk-Free Rates strongly recommends all market participants start replacing EONIA products with €STR products as soon as possible.[6] EURIBOR, the Euro InterBank Offered Rate, is not scheduled to be discontinued, as its methodology was updated to conform with the EU Benchmarks Regulation by January 1, 2020. Although contracts and financial instruments referencing EURIBOR do not need to transition to a new rate, contracts will need to incorporate new or improved fallback provisions. European Securities and Market Authority (ESMA) acknowledged that transition from LIBOR represents a significant challenge and highlighted the importance of timely disclosures of the implications for the firms.

Our benchmarking analysis

We evaluated the annual public filings of the US top 15 largest banks (as ranked by bankrate.com in 2019), ten of Europe's largest banks, and certain corporates for discussion of LIBOR in their 2018 and 2019 annual financial statements with two goals in mind: (1) to ascertain the industry's current perspective on the matter, and (2) to track any shift in disclosure from 2018.

Based on the result of our analysis, bank and corporate disclosures fell into the following categories:[7]

— Identified LIBOR as a risk

— Cited LIBOR as an industry risk

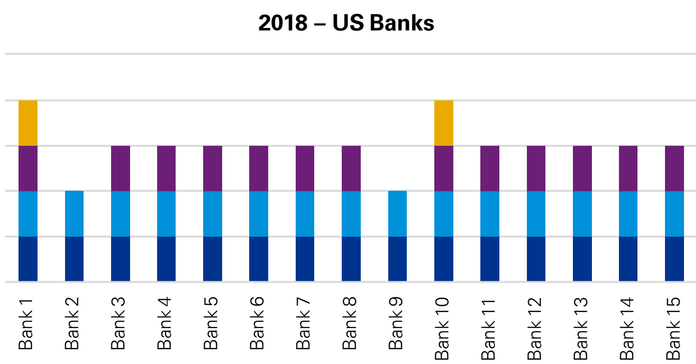
— Identified qualitative risks associated with LIBOR

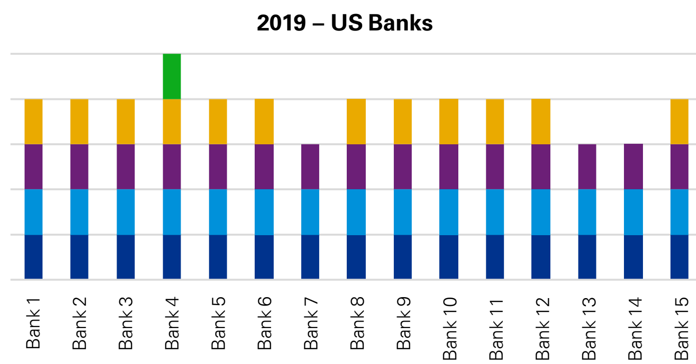
— Described remediation efforts to mitigate the impact of LIBOR

— Identified quantitative risks associated with LIBOR.

LIBOR Disclosure in Top 15 US Banks' Annual Reports

In 2019, US banks appeared to have made progress with LIBOR reform. For instance, all top 15 largest banks disclosed that they have continued to identify LIBOR reform exposures, including operational, financial, and market/liquidity risks. Nearly 75% of the top 15 banks disclosed the potential litigation and other types of disputes with clients, customers, counterparties and investors due to LIBOR reform. In addition, 80% of the top 15 banks enhanced their disclosure to include remediation efforts to mitigate the impact of LIBOR, while in 2018, only 13% of those banks disclosed remediation efforts. Furthermore, 60% of the top 15 banks disclosed their efforts to implement and adopt new fallback provisions that provide for the determination of replacement rates for LIBOR-linked products and contracts. Lastly, more than 60% of top 15 banks have introduced alternative reference rates in certain newly issued cash and derivative products.





Identified LIBOR as a risk, but only as a broader impact on assets

Cited LIBOR as an Industry risk

Identified qualitative risks associated with LIBOR

Described remediation efforts to mitigate the impact of LIBOR

Identified quantitative risks associated with LIBOR

Disclosure level	Number of Banks Pursuant to 2018 10-K	Number of Banks Pursuant to 2019 10-K
Identified LIBOR as a risk	15	15
Cited LIBOR as an industry risk	15	15
Identified qualitative risks associated with LIBOR	13	15
Described remediation efforts to mitigate the impact of LIBOR	2	12
Identified quantitative risks associated with LIBOR	0	1

[6] Source: EUR Working Group report on Euro Risk-Free Rates, February 19, 2020

[7] Note that each disclosure level increases in comprehensiveness. For example, for banks who fall into the last category of "identifies individual risks associated with transition and approach", they also fall into other categories except for "No reference to LIBORTransition".

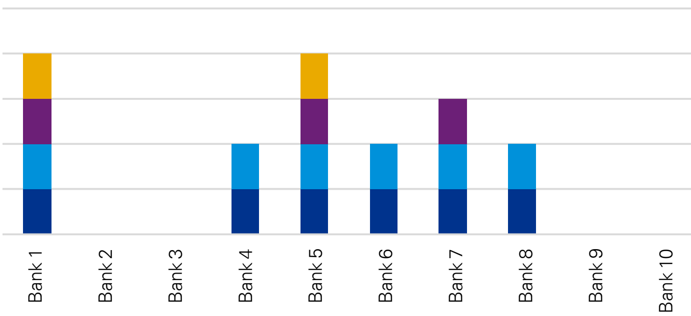
LIBOR Disclosure in 10 UK and European Banks' Annual Reports

The analysis of UK and European banks highlighted that UK banks are slightly ahead of the curve in disclosing the quantitative impact of the reform driven by two main factors – early adoption of IASB amendments that require specific disclosures and regulatory push on the timelines and transparency. While UK banks provided more quantitative information on the impact for the affected hedges, the level of qualitative disclosure related to the risks and mitigations as well as specific products' implications was similar across UK and US banks. The majority of European banks evaluated by us provided significantly fewer details.

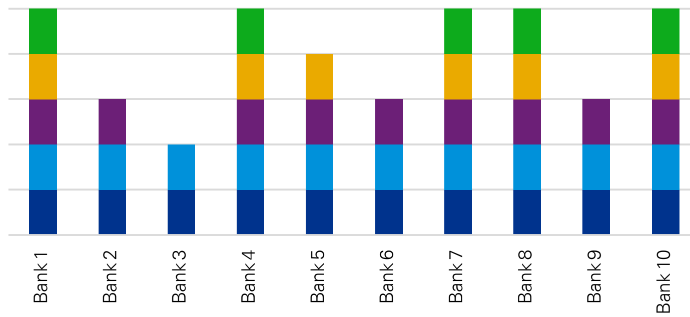
In 2019, 100% of UK and European banks disclosed that they recognized individual risks associated with the reform. Most UK banks detailed specific steps taken to mitigate the risks associated with LIBOR reform, including review of fallback provisions, active engagement with industry working groups and regulators, developing a communications strategy for customers, modifying operational models and systems, developing plans for new products, and transition plans for legacy products. Several banks indicated that they completed their first bilateral loan at alternative benchmark rate (SOFR and SONIA).

UK and European banks also appeared to have made progress with LIBOR reform, in that in 2018 only 70% of banks evaluated referenced LIBOR reform, and in 2019, 100% of those banks disclosed that they recognized individual risks associated with the reform. Additionally, 50% of UK and European banks evaluated identified quantitative risks associated with LIBOR, whereas in 2018, only 20% of banks disclosed remediation efforts to mitigate the impact of LIBOR, as each disclosure level increases comprehensiveness.

2018 – UK and EU Banks



2019 – UK and EU Banks



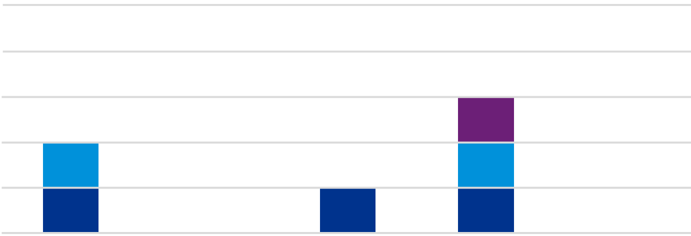
Identified LIBOR as a risk, but only as a broader impact on assets | Cited LIBOR as an Industry risk | Identified qualitative risks associated with LIBOR | Described remediation efforts to mitigate the impact of LIBOR | Identified quantitative risks associated with LIBOR

Disclosure level	Number of UK and EU Banks Pursuant to 2018 Annual Report	Number of UK and EU Banks Pursuant to 2019 Annual Report
Identified LIBOR as a risk	6	10
Cited LIBOR as an industry risk	6	10
Identified qualitative risks associated with LIBOR	3	9
Described remediation efforts to mitigate the impact of LIBOR	2	6
Identified quantitative risks associated with LIBOR	0	5

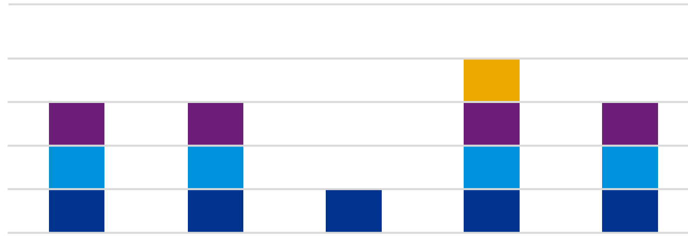
LIBOR Disclosure in Certain US Corporates' Annual Reports

In 2019, US corporates also appeared to have continued to make progress, with 80% of those evaluated by us saying that they had recognized individual industry risks associated with LIBOR reform, an increase from 20% in 2018. Both the automotive and hospitality representatives evaluated by us increased their LIBOR related risks and impact disclosures by 60% between 2018 and 2019. The government sponsored enterprise representative disclosed its efforts to create an enterprise wide program to identify and monitor exposure to LIBOR and update infrastructure to prepare for the LIBOR reform, amongst other things.

2018 – US Corporates



2019 – US Corporates



Identified LIBOR as a risk, but only as a broader impact on assets	Cited LIBOR as an Industry risk	Identified qualitative risks associated with LIBOR	Described remediation efforts to mitigate the impact of LIBOR	Identified quantitative risks associated with LIBOR

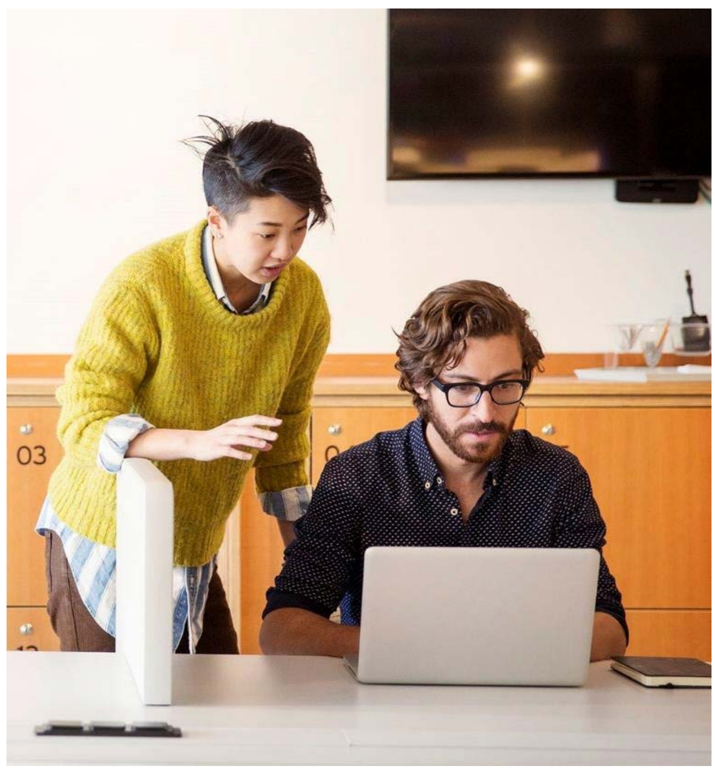
Disclosure level	Number of Companies Pursuant to 2018 10-K	Number of Companies Pursuant to 2019 10-K
Identified LIBOR as a risk	3	5
Cited LIBOR as an industry risk	1	4
Identified qualitative risks associated with LIBOR	1	4
Described remediation efforts to mitigate the impact of LIBOR	0	1
Identified quantitative risks associated with LIBOR	0	0

The road to 2021

Our current research shows how the banking industry has evolved in its management and disclosure of LIBOR risks—specifically from 2018 and following the aforementioned regulator communications.

Our analysis of the top 15 US banks', select US corporates', and 10 UK and European banks' 2019 annual financial statements indicate management's increased awareness of the variety of impacts this reform could have on their organizations. Between 2018 and 2019, the number of banks and companies that enhanced their LIBOR reform risk disclosure to include remediation efforts to mitigate the impact of LIBOR, as well as the identification of quantitative risks associated with LIBOR, increased. As a specific example of remediation efforts, one US bank established a LIBOR reform group with senior management and Board oversight. This group has focused its efforts on developing a strategy to transition LIBOR-linked contracts and processes across the bank to alternative reference rates, including the identification of product, system, and model exposures, incorporation of fallback language in new product contracts, and systemic process to escalate key risks. As an example of a quantitative risk disclosure, one European bank assessed the percentage of key balance sheet line items, such as derivatives, loans, and financial liabilities that are indexed to various LIBORs.

These results further reinforce the concerns that the discontinuation of LIBOR will indeed present risks that require attention across multiple frontline units of each organization.



Contact us

LIBOR, the interest rate benchmark that the industry has grown to love over the years, will inevitably disappear in 2021. Choosing the right partner to help navigate the LIBOR reform is key to your firm's success. KPMG has the experience to help make it a smooth journey

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