LIBOR transition for asset managers

February 2021

Why the transition from LIBOR?

Interbank Offered Rates (IBORs)

In response to the LIBOR manipulation scandal, on July 27, 2017, the UK Financial Conduct Authority announced that all currency variants of IBOR, including USD LIBOR, will be phased out

The transition presents safety and soundness risks for the financial markets so must be planned and executed carefully

On April 3, 2018, the Alternative Reference Rates Committee (ARRC) (part of the Federal Reserve) recommended replacing USD LIBOR with the "Secured Overnight Financing Rate" – or SOFR

SOFR is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities

Background

“The reforms to interest rate benchmarks will have a big impact across financial markets, from Wall Street to Main Street. Making sure the entire market appreciates the scale of the issue and takes early action is therefore a priority.

Given the scale of the task, this is not something that can be resolved in the months before end-2021. To ensure a successful and orderly transition, institutions need to be taking action – and starting now.”

Scott O’Malia, Chief Executive Officer, International Swaps and Derivatives Association (ISDA), 4 July 2018

Currency	Working group	Alternative RFR	Publication date
USD	Alternative Reference Rates Committee (ARRC)	Secured Overnight Financing Rate (SOFR)	April 2018
GBR	Working Group on Sterling Risk-Free Reference Rates	Reformed Sterling Overnight Index Average (SONIA)	April 2018
JPY	Study Group on Risk-Free Reference Rates	Tokyo Overnight Average rate (TONA)	December 2016
CHF	National Working Group on CHF Reference Rates	Swiss Average Rate Overnight (SARON)	August 2009
EUR	Working Group on Risk-Free Reference Rates for the Euro Area	Euro Short-Term Rate (ESTER)	Projected Prior to 2020

1 London Inter-Bank Offered Rate

2 The Financial Stability Board, Market Participants Group on Reforming Interest Rate Benchmarks: Final Report, July 2014. Available at: http://www.fsb.org/wp-content/uploads/r_140722b.pdf

3 Second Report, Alternative Reference Rate Committee, March 2018. Available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report

The U.K.’s Financial Conduct Authority (FCA) announced in July, 2017 that it will not compel or persuade panel banks to make LIBOR[1] submissions after the end of 2021. This declaration unleashed a flurry of activity around not only choosing alternative reference rates, but also developing the roadmap needed for transitioning to the new RFRs. On November 30, 2020, the ICE Benchmark Administration Ltd. proposed a revised USD LIBOR transition schedule. The impact of the revised transition went under consultation by US Inter-banking agencies. Proposed transition included one week and two month LIBOR settings after December 31, 2021 and all other LIBOR settings after June 30, 2023.

Inter-Bank Offered Rate (IBOR) is used as reference rate or benchmark of the average rate at which banks are able to borrow from one another in the short-term money markets. LIBOR is one of a number of interbank offered rates currently in use. It is calculated daily based on rates quoted by a panel of banks for five currencies and across seven maturities.

The combined gross notional exposure of contracts referenced to these interbank offered rates was estimated by the Financial Stability Board (FSB) at more than USD 370 trillion in 2014.[2] At the end of 2016, the estimated total exposure to USD LIBOR alone was nearly USD 200 trillion, spanning a broad range of market participants in a variety of products.[3]

Five currency Working Groups – USD, GBP, JPY, CHF and EUR – were formed to consider, recommend and promote alternative RFRs within their home jurisdictions. The five recommended alternative RFRs are being developed as primarily transactions-based and tied to overnight borrowing rates.

With a majority of sell-side firms already planning for the transition, KPMG professionals have so far seen fewer buy-side firms thinking about the impact the transition will have on their clients’ portfolios, and their agreements with counterparties and provider agreements.

Effect on financial agreements

Not limited to loan agreements

Will impact a number of financial instruments held by asset managers – financial products such as derivatives, bonds, loans, leases, and other structured products frequently reference LIBOR.

Fallback Provisions

New agreements should contain clauses that allow for transition to new base rate at a future date.

Existing agreements may be amended to include fallback clause.

‘Hardwired’ vs. ‘amendment’ approach.

Types of Adjustments

New reference rate, e.g., SOFR for USD LIBOR

Adjustments to spread above the base reference rate in order to account for the expected differences between the two base reference rates (generally representing term premium and credit risk)

Many counterparties (e.g., banks) are establishing working groups to consider how to incorporate fallback language in new contracts and amend existing contracts

Tax needs to consider how cessation of LIBOR and incorporation of fallback language into its contracts may impact the fund’s tax liability

U.S. federal tax implications

IRC Section 1001

Changing interest rate index referenced in a debt instrument from LIBOR to SOFR (or another reference rate), if there is no existing provision in the debt instrument for such a change, may constitute a significant modification under Reg. section 1.1001-3

Treas. Reg. section 1.1001-3 does not directly deal with modifications of derivatives and other non-debt agreements

— Could result in termination and re-issuance of contract

— Gain/loss recognition

— “Legging out” of hedging/integrated transactions

Other Potential Consequences

Questions around source and character of one-time payments

Loss of grandfathered status for certain contracts (e.g., FATCA)

Complexities with applying the OID rules

Disqualification under the REMIC rules

Proposed IRS regulations: October 2019

Intended to minimize market disruption and reduce tax uncertainty as global markets shift away from IBORs

Taxpayer friendly; no section 1001 realization event …

— When replacing IBOR reference rates with qualified rates in debt instruments or derivatives,

— If the FMV of the modified instrument or contract is substantially equivalent to its FMV before the change was made (see following slide), and

— Same currency is used

Rule also applies to any associated changes that are reasonably necessary to implement the replacement rate

Proposed IRS regulations: October 2019 (continued)

FMV safe harbors:

— **Historic average rate safe-harbor:** FMV equivalence requirement satisfied if, at the time of the modification, the historic average of the IBOR-referencing rate is within 25 basis points of the historic average of the rate that replaces it

— **Arm's length negotiations safe-harbor**: If parties to contract are unrelated, and the parties determine based on bona fide, arm's length negotiations between the parties, that the FMV of the contract before the alteration or modification is substantially equivalent to the FMV of the contract after the alteration or modification

One-time payments:

— Source and character of one-time payments made by parties to account for differences between the IBOR and replacement rate will have the same source and character that would otherwise apply to a payment made by the payor regarding the debt instrument or non-debt contract that is altered or modified

KPMG

Rev. Proc. 2020-44 (October 2020)

Reason for guidance

The Alternative Reference Rates Committee "ARRC" (https://www.newyorkfed.org/arrc) and ISDA submitted written comments to the Treasury Department and IRS requesting guidance for the adoption of fallback language recommended by the ARRC and ISDA (through the ISDA Protocol)

The comment letters recommended issuing guidance that is separate from finalizing the proposed regulations and specific to the ARRC fallbacks and the ISDA Protocol

Rev. Proc. 2020-44 was issued as interim guidance in advance of finalizing the proposed regulations to support the adoption of the ARRC fallbacks and the ISDA Protocol

Generally provides that the modification of a contract to incorporate the terms of an ARRC fallback, an ISDA fallback or certain variants of an ARRC or ISDA fallback does not

Result in an exchange under Treas. Reg. sectio 1.1001-1(a)

Result in legging out of a integrated transaction, terminating either leg of a hedging transaction, or otherwise severing integration

Outstanding issues

Changes to contracts that use an "amendment approach" are not covered by the Rev. Proc.

A one-time payment is not a permissible deviation under the Rev. Proc., whereas under the proposed regulations a one-time payment may accompany a rate change and associated alterations and not disqualify the transaction from being treated as a non-realization event, if the FMV test is met

Any non-permitted deviation from the Rev. Proc. has to be analyzed under the proposed regulations (or under general section 1001 principles)

Example 1 – Corporate loan

Original terms:

Fund owns a syndicated corporate loan (the "**Loan**").

- Principal amount - $500m. Fund owns $80m of the Loan (with the syndicating bank and other investors participating in the syndication taking the remaining $420 million).
- Interest rate - LIBOR plus 2.50%

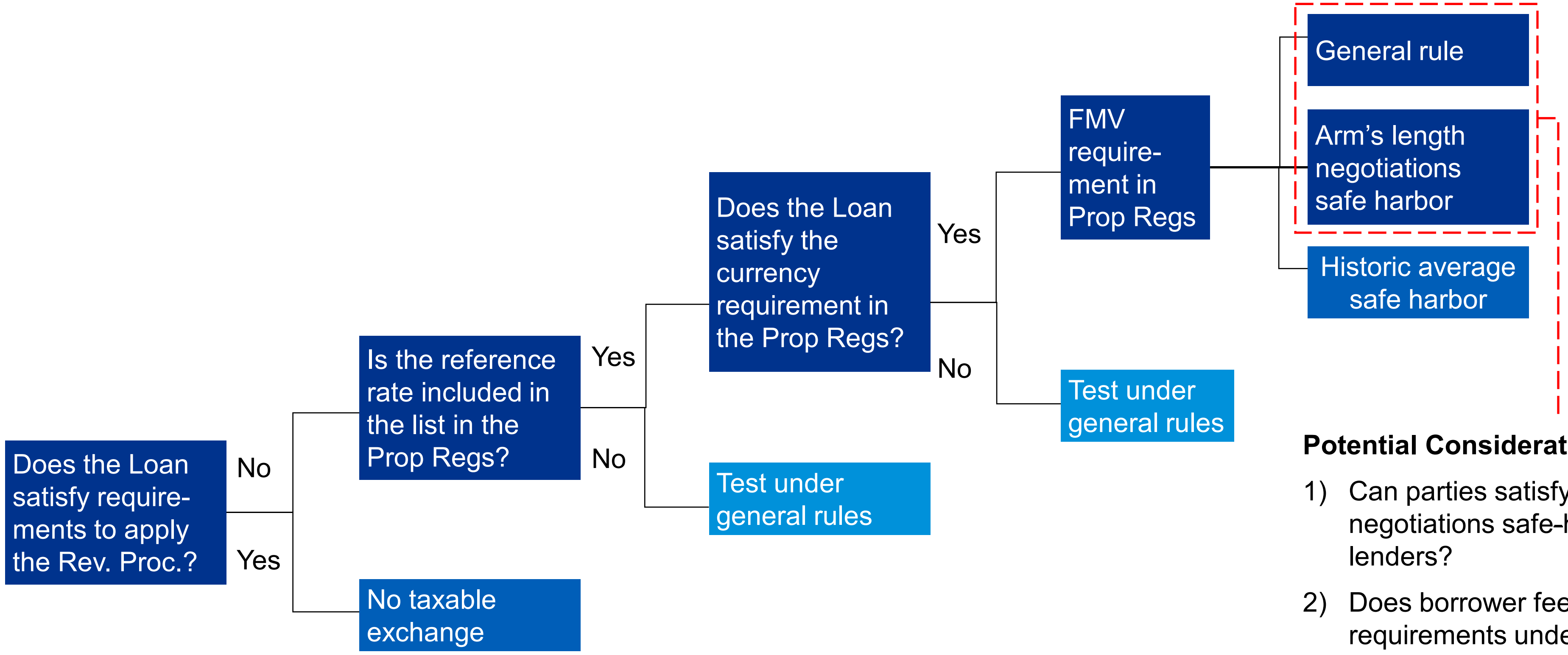
Amendment to incorporate fallback language

- On December 15, 2020, the syndicating bank (representing itself and others in the syndicate) and the corporate borrower modify the terms of the agreement to take into account the transition from LIBOR.
- The parties do not adopt the ARRC recommended fallback language.
- ***Upon the occurrence of a Benchmark Transition Event, the rate will equal the prime rate plus a spread adjustment. The spread adjustment will be selected in connection with the Benchmark Transition Event.***
- The only other changes to the agreement are administerial to help facilitate the incorporation of fallback language.

On the date the parties amend the agreement to incorporate fallback language, the Loan is worth 110% of the principal balance.

Example 1 – Corporate loan (continued)

Decision Tree



Potential Considerations

1) Can parties satisfy arm's length negotiations safe-harbor with passive lenders?
2) Does borrower feel comfortable with requirements under the arm's length negotiations safe harbor?
3) What documentation is required?

Example 1 – Corporate loan (continued)

Potential consequences if there is a taxable exchange

Lenders/Investors

— Loan subject to mark-to-market – likely minimal impact

— Loan not subject to mark-to-market

- Loan has a strong possibility of being publicly traded (issue exceeds $100 million)
- If Loan is publicly traded, Fund realizes gain of $8
- Is Loan a security and the transaction is treated as a tax-free recapitalization?

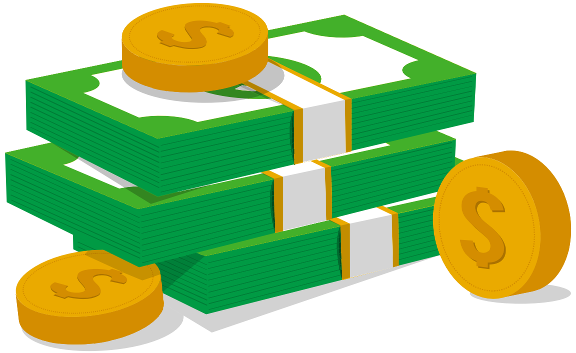
Borrower

— If Loan is publicly traded, the borrower recognizes an interest deduction of $50

— The borrower may also be required to mark-to-market any hedging transactions

How do interest accruals take into account the uncertainty around the timing of the Benchmark Transition Event?

Are the parties required to re-analyze Loan at the time of the Benchmark Transition Event?



Example 2 – Hedge contracts

Borrowings: Hedge fund ("**Fund**") has acquired a fixed rate, publicly traded note (the "**Note**"). The Note provides for a fixed interest rate that is due quarterly. All principal is due on the maturity date.

Hedging: Fund enters into an interest rate swap (the "**Hedge**") that synthetically converts the Note to a variable rate debt instrument providing for monthly interest payments based on LIBOR. **For U.S. tax purposes, Fund has elected to integrate the Hedge with the Note under Treas. Reg. section 1.1275-6 to create a synthetic, variable rate debt instrument.**

Amendment to incorporate fallback language

- No amendments are made to the Note in connection with LIBOR cessation
- Fund amends the Hedge to take into account LIBOR cessation
  - Upon the occurrence of a Benchmark Transition Event, the reference rate in the Hedge will transition from LIBOR to the Fed Funds Rate
  - The parties do not adopt the ARRC recommended fallback language

Potential consequences if there is a section 1001 event

- Does incorporating the fallback language give rise to a legging out transaction and require Fund to mark-to-market the <u>integrated</u> instrument?
  - How is Fund required to account for the instruments prospectively? Is the Hedge now a capital asset?
  - Is there also a leg out even if there is not a section 1001 event, but there is a change to the Hedge's payment dates?
- What are the consequences if the Note references other property (e.g., currency, commodity), and the Hedge synthetically converts the Notes into a U.S. dollar, variable rate debt instrument?

Tax community recommendations

New York State Bar Association has recommended, among other things, that:

— For unrelated parties, the "Substantial-Equivalence-of-FMV" rule should apply only in cases involving "Qualifying IBOR Alterations" (i.e., alterations that replace an IBOR-referencing rate with a "qualified rate" and "associated alterations") **and other non-associated alterations.**

— The arm's length negotiation safe harbor should be clarified and simplified, e.g., the issuer determines the FMV of the modified debt and discloses to the holders (similar to Treas. Reg. §section 1.1273-2(f)(9)).

— One-time payments treated as associated alterations should be taken into account over the remaining life of the debt instrument as original issue discount.

— One-time payment on an NPC (i.e., a swap) should be treated as a non-periodic payment taken into account over the remaining life of the NPC. For other non-debt contracts, one-time payments should be taken into account in a manner that clearly reflects income.[1]

In its March 2020 comment letter, the ARRC recommended a similar approach with respect to the Substantial-Equivalence-of-FMV rule.

— The ARRC recommended a more flexible approach to account for any one-time payments.

[1] NYSBA Tax Section, Report on IBOR Transition Proposed Regulations (Dec. 27, 2019)

LIBOR Tax review at KPMG

Identify Contracts Subject To Modification

Scrutinizing contracts is time consuming and difficult to manage on a global scale. Any change entails reviewing all in-scope contracts to determine the right transition path. When done manually, this places a heavy burden on finance, legal, and operations teams. To address these challenges, KPMG brings together two assets to automate contract analysis and remediation:

- Ignite is KPMG's global artificial intelligence platform. It enables KPMG to rapidly process and interpret large volumes of contracts and other types of unstructured data using state-of-the-art machine learning and natural language processing.
- Appian is a low code, application development platform that accelerates the creation of high-impact business applications. Appian is a fast path from idea to application, enabling document sharing, customizable business rules, real-time reporting, and powerful process management

By automating repetitive, rule-driven processes with KPMG's AI-enabled contract management and workflow platform, you have the ability to realize lower costs, greater accuracy, rapid deployment, and improved compliance.

LIBOR Tax review at KPMG (continued)

Review Tax Modifications

— KPMG tax professionals around the globe have been preparing and advising funds on the upcoming LIBOR migration.

— After the relevant contracts are identified, the amendments must be analyzed to determine if taxable modification risks are present.

— KPMG tax can group contracts into risk buckets and provide amendment suggestions to minimize or eliminate tax risks.

— As part of the tax risk bucketing exercise KPMG tax may also ascertain opportunities for tax enhancements to financial contracts.

KPMG’s Approach to LIBOR transition

Operational readiness

While the efforts to prepare for the transition away from LIBOR will be significant, operational readiness may be most demanding of all.

KPMG professionals are guiding numerous firms through the planning and implementation of necessary changes to prepare for new products leveraging alternative risk-free rates and the remediation of legacy contracts referencing LIBOR.

The number of operational factors that must be considered grows quickly when links to counterparties, products, systems and legal departments are entered into the mix. Structural differences between LIBOR and its proposed replacements make operational uncertainty unavoidable. These challenges are further exacerbated by looming unknowns in market conventions, market structure and legal certainty—not to mention the rapidly approaching LIBOR end-date.

Key challenges for Asset Managers

value transfers:

The transition to an overnight Risk Free Rate ("RFR") will lead to changes in the value of existing positions, which may be more or less favorable to counterparties. Internal valuation models will need to be calibrated for replacement RFRs. Firms will need to establish where IBORs have been used and how to best transition away from them.

Legacy contract documentation:

Investment management agreements and fund documentation may reference IBORs for benchmark purposes. Firms should look to minimize the time before more robust contract language is widely incorporated, which may involve being willing to change language over time, rather than forgoing any changes until absolute certainty is achieved.

Market Pricing:

No replacement will match 1:1 to LIBOR, which introduces basis risk. Firms will need solid understanding of where responsibility lies in replacement rate selection, how third-party pricing services will treat fallback language, or amend associated agreements, and report the change in value.

Technology:

Many institutions maintain legacy systems designed around monthly, or longer, updates to LIBOR. Moving to an overnight rate will require a daily reconciliation for interest accrual. Firms will need to assess their data feed and system functionality requirements.

Operations:

The shift away from periodic LIBOR updates may require re-evaluating existing processes, especially where those processes have been manual. In some cases this will require development of EUC's, or implementation of controls around the new calculation process.

Derivatives:

We have seen several instances where a derivative's fallback language conflicts with the underlying contracts associated with the hedged risk. In these cases there is potential for ineffective hedging results. Knowing if and where these conflicts are is essential to protecting a derivative portfolio.

end-to-end program operating model

1. Governance and oversight

- Oversee implementation of policies, procedures and stakeholder roles and responsibilities
- Establish issues and escalation framework for issue escalation, QA/QC review, and senior leadership review
- Monitor remediation efforts

2. strategy

- Industry development, involvement, and monitoring
- Timing for cutting over internal products to new reference rates
- Product pricing decisioning and global rate reference rate impacts

3. Scope/impact inventory

- Business Units
- Products
- Systems/Applications (in-house and third party dependent)
- Vendors (systems/application and operations)
- Models
- Internal Functions

Robust Change Management

4. Contract change management

- Assess impact across portfolio of contracts
- Define amendment language
- Execute amendments and track compliance

5. Model remediation

- Update models
- Back-testing and validation
- Update model documentation

6. Ops and tech remediation

- Reference data systems
- New product implementation
- Existing contract/position migration

7. Client and regulatory communication

- Develop communication strategies
- Enhance employee awareness through the design and deployment of communications and trainings
- Execute call center and relationship manager trainings

8. Accounting, tax and internal audit

- Determine exposure to transition value
- Assess impact to hedge accounting & disclosures/reporting requirements
- Quantify any potential tax impacts

9. Post transaction activities

- Ongoing monitoring and reporting
- Remediation activities

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