LIBOR Transition - Valuation Guide

Valuation Standards Board
and
ICAI Registered Valuers Organisation
The Institute of Chartered Accountants of India
(Setup by an Act of Parliament)
New Delhi

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MESSAGE

LIBOR, the London Inter-Bank Offered Rate, is the most widely used IBOR in financial transactions globally. Cessation of LIBOR has initiated a worldwide transition of financial institutions from old benchmarks to new Alternative Reference Rates (ARR). This transition will impact the existing exposures as well as any future contracts using LIBOR as a reference rate and will also require changes in systems, processes and tax and accounting treatment at entities that uses financial instruments.

This booklet "LIBOR Transition – Valuation Guide" provides a brief summary of LIBOR history and way forward post its cessation and also highlights key points to be considered by Registered Valuers and Stakeholders as a part of this transition. Since LIBOR has been used for long, this transition will be a complex exercise for banks and entities using financial instruments.

I extend my appreciation to the members of the Valuation Standards Board (VSB) of ICAI under the Chairmanship of CA. Anil S. Bhandari, Vice Chairman CA. M. P. VijayKumar and my colleagues on the Board of ICAI Registered Valuers Organisation (ICAI RVO) Shri Pawan Singh Tomar, Shri Ashok Haldia, Prof. Anil Saini, CA. Nihar N. Jambusaria & CA. Prafulla P. Chhajed for their collective efforts and support.

I also appreciate the efforts of Shri. Rakesh Sehgal, Managing Director ICAI RVO assisted by CA. Sarika Singhal, Officiating CEO ICAI RVO and Secretary, Valuation Standards Board and Ms. S. Rita, Deputy Secretary ICAI for their significant contribution in finalisation of this booklet.

I am confident that the members and other stakeholders will find this publication useful in guiding and supporting them in their professional endeavour.

Date: 3rd February, 2022 **Rajeev Kher**

Place: New Delhi **Chairperson and Independent Director, ICAI RVO**

MESSAGE

The London Interbank Offered Rate (LIBOR) is the benchmark interest rate at which global banks lend to one another. It was also used as a reference rate for many financial instruments in both financial markets and commercial fields. On 5th March 2021, LIBOR's administrator, ICE Benchmarks Administration (the "IBA"), and LIBOR's regulator, the U.K. Financial Conduct Authority (the "FCA"), announced that LIBOR, for most of the settings, will no longer be provided with effect from 31st December 2021.

Valuers and Treasury Managers need to be prepared for the transition away from LIBOR and the adoption of Alternative Reference Rates (ARR) to be developed in various jurisdictions. The Reserve Bank of India (RBI) has also issued an advisory emphasizing the need for preparedness for the transition from LIBOR and has advised banks to use any widely accepted ARR. RBI has also advised Banks to use Adjusted Mumbai Interbank Forward Outright Rate (Adjusted MIFOR) and Modified MIFOR for legacy contracts and new contracts respectively.

I am happy that the Valuation Standards Board (VSB) of ICAI and ICAI Registered Valuers Organisation (RVO) has decided to publish "LIBOR Transition – Valuation Guide" with an objective to guide members about the way forward on LIBOR Transition.

I compliment the efforts of all the Board Members of ICAI RVO under the Chairmanship of Shri Rajiv Kher, and the members on the Board of Valuation Standards Board (VSB) of ICAI under the Chairmanship of CA. Anil S. Bhandari and Vice Chairman CA. M. P. Vijay Kumar, for jointly bringing out this publication for the benefit of members and other stakeholders.

I am confident that this publication would be extremely helpful for the members and other stakeholders.

CA. Nihar N. Jambusaria
President, ICAI
Director, ICAI RVO

Date: 3rd February, 2022
Place: New Delhi

MESSAGE

The cessation of LIBOR changed the pricing, valuation, and risk management practices for all the entities that use financial instruments. Valuation Professionals and Finance Executives are expected to perform a detailed assessment of the impact on the financials of these entities due to this transition. Considering the complexity of the subject, Valuers are also expected to communicate and educate their clients on LIBOR Transition.

At this juncture, I accolade the efforts of the Valuation Standards Board (VSB) of ICAI and ICAI Registered Valuers Organisation (ICAI RVO) for taking the collective efforts in bringing out this publication "LIBOR Transition – Valuation Guide", which outlines the key challenges that arose for valuation professionals from the cessation of LIBOR and also provides guidance for the way forward.

I extend my appreciation to the members of the Board of ICAI RVO and the Valuation Standards Board of ICAI and especially to CA. Anil S. Bhandari, Chairman, Valuation Standards Board and CA. M. P. Vijay Kumar, Vice-Chairman, Valuation Standards Board for bringing out this publication for the benefit of members and other stakeholders.

I am sure that the members and other stakeholders will find this publication extremely useful in discharging their professional duties.

Date: 3rd February, 2022
Place: New Delhi

CA. (Dr.) Debashis Mitra
Vice-President, ICAI

MESSAGE

The London Inter-Bank Offered Rate, or LIBOR, has been the reference rate for financial markets globally for decades. Lenders, including banks and other financial institutions, used LIBOR as the benchmark for determining interest rates for various debt instruments. In 2017, the Financial Conduct Authority (FCA), UK, announced that it would not use its legal power to mandate banks to poll LIBOR beyond the end of 2021.

Cessation of LIBOR with effect from 31st December 2021 has created challenges for the valuation of financial instruments. All the entities that use financial instruments have to ascertain their exposure and determine the impact that the transition will have on their valuation process. The booklet "LIBOR Transition – Valuation Guide" aims to guide the valuers and other stakeholders about the way forward, the concept of fall-back rates and also includes an eight steps Valuers checklist to LIBOR Transition.

We would like to appreciate and thank CA. Parag Kulkarni for preparing the draft of "LIBOR Transition – Valuation Guide". We would also like to thank CA. Anil Mittal and his team, from ICICI Bank, for their vital contribution in finalisation of this publication.

We commend the efforts of Shri Rakesh Sehgal, Managing Director, ICAI RVO; CA. Sarika Singhal, Officiating CEO, ICAI RVO and Secretary VSB, ICAI and Ms. S. Rita, Deputy Secretary ICAI for their contribution in finalisation of this Concept Paper and also their team members viz. Ms. Seema Jangid, Assistant Secretary ICAI and CA. Pragya Agrawal, Assistant Project Officer ICAI for their technical and administrative support.

We are sure that the members and other stakeholders will find this publication extremely useful in guiding and supporting them in their professional endeavours.

CA. Anil S. Bhandari
Chairman,
Valuation Standards Board

CA. M. P. Vijay Kumar
Vice-Chairman,
Valuation Standards Board

Date: 3rd February, 2022
Place: New Delhi

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1. Introduction

The use of LIBOR interest rates can be found from the surge of the Eurodollar market (US dollar denominated deposits held outside of the US) in branches of banks outside the US in the 1960s. The origin of the term 'LIBOR' has been credited to a Greek banker called Minos Zombanakis, who was running the London branch of Manufacturer's Hanover. In 1969, he organised an $80 million syndicated loan for the Shah of Iran, referenced to what he called a London interbank offered rate.

In the beginning, LIBOR was calculated for three currencies – the US dollar, the British pound and the Japanese yen. By the passage of time, more currencies / maturities were added. In year 2021, 35 LIBOR rates were posted each day for seven maturities each for five major currencies, viz., the Swiss franc, the Euro, the Pound sterling, the Japanese yen, and the US dollar. LIBOR rates are computed as a 'trimmed mean[1]' of rates obtained from major banks based on responses to the question: 'At what rate could you borrow in a reasonable market just prior to 11 a.m.?'

The subjective nature of the question, especially related to timing and size – 'reasonable market size' and 'just before 11 a.m.' – leaves LIBOR vulnerable to manipulation.

The evolution of the repo market led to a decay in the volumes of unsecured interbank transactions. As these transactions shrunk, LIBOR rates became increasingly un-verifiable and increasingly reliant on expert judgement of banks. Conflict of interest was inherent – the polling banks have 'significant' presence in related markets, but they also hold large derivative and loan contracts that are priced by using LIBOR rates.

[1] A trimmed mean (similar to an adjusted mean) is a method of averaging that removes a small-designated percentage of the largest and smallest values before calculating the mean. After removing the specified outlier observations, the trimmed mean is found using a standard arithmetic averaging formula. The use of a trimmed mean helps eliminate the influence of outliers or data points on the tails that may unfairly affect the traditional or arithmetic mean.

2. Deficiencies in LIBOR

Discrepancies were first observed during 2007-08 when the interbank rates did not mirror the actual rates at which banks lent to each other. Wall Street Journal article and in various research papers in 2008 reported possibility of misrepresentation of the facts – reported LIBOR was significantly lower than those implied by prevailing credit default swap (CDS).

This revelation exposed incentive for banks to manipulate LIBOR through which banks establish their credit-worthiness. In sideway market conditions, such manipulation can be used to further advantage open trading positions.

Post this publication, there was an immediate spike in the 3-month USD LIBOR rate. This triggered off investigations into the LIBOR fixation process. By 2012, manipulations in LIBOR fixation were established and banks were levied with fines totalling about $ 9 billion for misconduct.[2]

In 2012, ground-breaking revelations were made. The LIBOR was found to have been manipulated by individuals at various financial institutions. Consequently, the news of manipulation sent tremors in the financial market. Credibility of a financial reference used to price and determine payoffs for trillions of dollars of loans/bonds/derivatives was under suspicion. The heart of the problem was the fact that LIBOR prices the market. In affirmative action, in 2017, the Financial Conduct Authority (FCA), UK, announced that it would not use its legal power to mandate banks to poll LIBOR beyond end-2021.

[2] Source: RBI Archive Documents

3. Background

The Financial Conduct Authority (FCA), UK, in a press statement dated March 05, 2021 announced that all LIBOR settings will either cease to be provided by any administrator or no longer be representative:

- immediately after December 31, 2021, in the case of all Pound sterling, Euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month US dollar settings; and
- immediately after June 30, 2023, in the case of the remaining US dollar settings.

The transition away from LIBOR and the adoption of Alternative Reference Rates (ARR) developed in various jurisdictions is a significant event that needs to be carefully prepared for. Valuers are advised to assess exposure of entities being valued to LIBOR based financial instruments that will mature after the cessation of the LIBOR.

4. LIBOR Cessation

After December 31, 2021, all CHF and EUR LIBOR settings, the 1 Week and 2 Months USD LIBOR settings, and the Overnight/Spot Next, 1 Week, 2 Months and 12 Months GBP and JPY LIBOR settings have ceased to be published.

5 USD LIBOR settings that will be continued to be published are as follows.

1. Overnight
2. 1 Month
3. 3 Month
4. 6 Month
5. 12 Month

5 US Dollar Settings	**Other 30 Settings** ***(all non-US dollar tenors plus one-week and two-month US dollar LIBOR)***
They will be continued to be published on representative basis until 30.06.2023	They are either ceased or are not representative after 31.12.2021

5. Synthetic LIBOR for GBP and Japanese Yen Settings

The LIBOR benchmark administrator shall continue to publish 1, 3 and 6-month Sterling and Japanese Yen LIBOR settings ("LIBOR Settings") under a synthetic methodology (synthetic LIBOR), based on term risk-free rates, for the duration of 2022. This has been done to avoid disruption to legacy contracts which had reference to the LIBOR Settings. The LIBOR Settings shall only be available for use in some legacy contracts and are not available for use in new contracts.

6. Valuer's Assessment Matrix

Treasury heads and valuers are expected to perform broad assessments covering following areas:

i) Exposure Assessment

- Contracts such as currency swaps and interest rates swaps are directly impacted because of LIBOR cessation/ transition.
- However, there are some other derivative contracts such as forward contracts that are indirectly impacted because of LIBOR cessation/ transition. Typically, forward contracts are valued referring to LIBOR as a discount rate.
- Identification of direct and indirect impact on entity's existing set of contracts is required.

ii) Off-Balance Sheet Items

- Example of Products - interest rate swaps, cross currency swaps, caps & floors, FX Forwards, FX Swap, FX Flexi-forward3, FX Option, FX NDF 4& FX NDF Swaps
- Along with discounting, the impact is from an MTM/valuation perspective.
- Typically, these items include exposure to derivative contracts.
- Most of the bankers have replicated the ISDA protocol for derivative contracts.
- Consequently, the provision for fallback rate is present.

iii) On-Balance Sheet Items

- Example of Products – floating rate Term Loans, Working Capital facilities & Borrowings.

[3]A flexible forward contract (FFC) is an FX contract that allows the contracting party to fix the buy or sell rate of a currency pair at a particular time, between two set dates, for a specific amount. In addition, and depending on the contracting party's business, they can either exchange the full or partial amount(s) at any time during the contract's duration, at the pre-agreed rate.

[4] FX NDF = FX Non Deliverable Forward. It is a two-party currency derivatives contract to exchange cash flows between the NDF and prevailing spot rates.

- The impact is from a cash flow estimation perspective.
- It is observed that, lenders mimic the ISDA protocol (on derivative) that covers the shift from LIBOR to fallback rate even for non-derivative contracts.
- Consequently, despite the shift from one rate to another, hedging relationship remains intact.
- However, in some situations, there is a possibility of 'value transfer' on account of renegotiation between lenders and borrowers (on account of improved/ deteriorated credit risk).
- Basis risk can arise if there is a difference between the credit spread adjustment calculation methodology between derivatives and cash products. Industry working groups have been strongly advocating consistency across derivatives and cash products. As long as there is consistency between the credit spread adjustment calculation methodologies, the basis risk between derivatives and cash products should be low.
- Valuers are expected to take cognizance of both elements – change in market risk (represented by change from one rate to another rate) and change in credit risk while valuing non-derivative element post contract modification.

iv) Client Communication

- Considering the complexity of the subject, valuers are expected to communicate and educate client on LIBOR Transition.
- There are certain trade financing contracts such as 'securitization' which requires transfer of consideration valued at 'present value' of future cashflows. Historically, such present value was calculated with reference to LIBOR curves (which in fact were forward looking and remained fixed (or known) until the date of maturity). For e.g., 1 month LIBOR curve can be used to calculate present value on 1st January for a cashflow due on 31st January.
- After the transition from LIBOR to ARR, which are overnight rates or rates in arrears, a commercial challenge is to identify a rate applicable for discounting at the zero date for a remaining credit period (of say 31 days). ARR is a rate of past transactions. Thus, it may not represent a valid discounting rate that can be applied for calculating present value on 1st January for a cashflow due on 31st January. Hence, it is important that clients, valuers, and bankers negotiate and finalise on mutually agreeable terms.

v) System Development

- Valuer may need to modify its present valuation model in order to accommodate the transition from LIBOR to alternate reference rate.
- Similarly, core treasury system may also need an update.

7. Way Forward

RBI has advised banks to use Adjusted Mumbai Interbank Forward Outright Rate (Adjusted MIFOR) and Modified MIFOR that can be used for legacy contracts and new contracts respectively. Thus, for legacy contracts, rupee fixed leg to be valued using Adjusted MIFOR and for new contracts, rupee fixed leg to be valued using Modified MIFOR.

The MIFOR Curve is an implied Rupee interest rate curve derived from the Forward Premia Curve and the USD LIBOR curve. It is computed for six tenors, viz. the Overnight, 1 month, 2 months, 3 months, 6 months and 12 months. In light of the permanent cessation of LIBOR by the end of 2021, MIFOR Curve would be replaced by the Adjusted MIFOR Curve and is applicable for legacy contracts (for rupee fixed leg). Adjusted MIFOR Curve is to be computed using the All-in Fallback Rate to the USD LIBOR curve and the Forward Premia Curve.

On account of cessation of LIBOR settings, legacy contract will fall back on an alternate reference rate identified as 'All-in Fallback Rate' in the contract. The All-in Fallback Rate is computed as sum of the Adjusted SOFR and the Spread Adjustment. The Adjusted SOFR, is the overnight SOFR compounded in arrears The Spread Adjustment value is a historical median spread between the LIBOR and Adjusted SOFR for a 5-year lookback period using the methodology from IBOR Fallback Rate Adjustment Rule Book.

8. Concept of Fallback Rate

Fallback Rate	**=**	**Adjusted Reference Rate**	**(+)**	**Spread Adjustment**

Lenders/ Banks entered into LIBOR based derivative contracts pre December, 2021 along with a facility to fall back on a new benchmark once LIBOR cesses to be a representative reference rate i.e. for a period post 31st December, 2021. Consequently, agreements with 'fallback condition' will refer to a new benchmark rate instead of LIBOR for identification of related cashflows.

Post 31st December, 2021 Lenders/ Bankers do not use LIBOR as a reference rate, but rather they use accepted alternative reference rate such as SOFR in USA.

9. Rationale of Adjustments

i) To account for the fact that IBORs have a term structure (e.g., 1-month, 2-month, etc.) whereas RFRs are overnight rates, the RFRs to be compounded in arrears over a period similar to the applicable IBOR tenor (e.g., 30 days for 1-month, 60 days for 2-month, etc.). These compounded RFRs are each generally referred to as the **"Adjusted Reference Rate**".

ii) To account for the (nearly) risk-free nature of the RFRs. The liquidity characteristics and supply/demand factors affecting IBORs, a spread adjustment to be calculated for each RFR/IBOR pair (per tenor) using a five-year historical median calculation. These calculations are each generally referred to as the "Spread Adjustment".

iii) LIBOR and RFRs are structurally different. RFRs will be different from the corresponding LIBOR benchmark rates due to the absence of liquidity and credit risk. Thus, in order to make the rates more comparable and in line with each other, a credit adjustment spread (CAS) is added to the risk-free rate.

iv) The credit adjustment spread calculated as per the ISDA methodology uses the 5-year lookback historical median approach. Under this method, the credit adjustment spread is calculated as the median difference over a historic five-year period between the relevant LIBOR being replaced and the corresponding risk-free rate compounded in arrears for the term equivalent to the term of the LIBOR it replaces.

v) Adding (1) and (2) together on a per RFR, per tenor basis for the resulting "Fallback Rate".

10. Overview of Alternate Reference Rates in Various Markets

	USA	UK	EU	Switzerland	Japan
ARR	Secured Overnight Financing Rate (SOFR)	Sterling Overnight Interbank Average Rate (SONIA)	Euro Short Term Rate (ESTR)	Swiss Average Rate Overnight (SARON)	Tokyo Overnight Average Rate (TONAR)
Secured	Yes	No	No	Yes	No
Tenor	Overnight	Overnight	Overnight	Overnight	Overnight
Counterparties	Banks and non-banks	Banks and non-banks	Banks and non-banks	Banks only	Banks and non-banks
Key Features	• Fully transaction based • Secured overnight rate with robust underlying money market	• Fully transaction based • Unsecured overnight rate with robust underlying money market	• Fully transaction based • Reflects the unsecured wholesale euro borrowing costs of Euro Banks	• Fully transaction based (+) quotes • Secured overnight rate since 2009 reflecting interest paid on repo	• Fully transaction based • Unsecured overnight rate based on overnight call rate market
Publication Time	8:00am ET	9:00am BST	8:00am CET	8:30am CET	10:00am JST

11. Difference between LIBOR and RFR

Transitioning to the RFRs will be a demanding and complex process for the industry as RFRs are structurally different from IBORs. They are overnight rates and exhibit different liquidity characteristics and supply/demand issues than IBORs.

The LIBOR is a combination of interbank rates comprising credit risk premia, term premia and liquidity premia. As against this, ARRs are overnight benchmark rates, which lack a term structure and a credit risk component.

12. LIBOR Transition Challenge

We can categorise derivative contracts into three categories:

i) Contracts entered and matured before 31.12.2021;
ii) Contracts entered before 31.12.2021 but maturing before 30.06.2023, and
iii) Contracts maturing beyond 30.06.2023

Let us analyse each of these contracts one by one.

i) Contracts entered and matured before 31st December, 2021

LIBOR settings for these contracts were available until 31st December, 2021. Consequently, these contracts are not subject to valuation challenges.

ii) Contracts entered before 31st December, 2021 but maturing before 30th June, 2023

These contracts can be referred to as 'Legacy Contracts'. 5 US Dollar Settings will be published until 30th June, 2023 on a representative basis. Other 30 Settings *(all non-US dollar tenors plus one-week and two-month US dollar LIBOR)* will not be published post 31st December, 2021. Thus, we need to further analyse the contracts in the following two types:

a. 5 US Dollar Settings

There are two possibilities:

- Fallback rate is mentioned in the contract
  Cashflows to be calculated with reference to new benchmark i.e. with reference to fallback rate

Valuers to use 'Adjusted MIFOR' for discounting rupee cashflows on notional amount from the derivative contract.
Example - If both parties to the trade have adhered to the International Swaps and Derivatives Association (ISDA) IBORs 2020 Fallback Protocol, or have bilaterally

agreed, the interest rate for USD for post LIBOR cessation period would be calculated on a compounded SOFR in arrears methodology plus the credit adjustment spread (CAS)

- Fallback rate is not mentioned in the contract
  These settings will be continued to be published.

  Valuers can use the published data to identify cashflows from the contract and to identify the discount rates.

b. Other 30 Settings (all non-US dollar tenors plus one-week and two-month US dollar LIBOR)

There are two possibilities

- Fallback rate is mentioned in the contract
  Cashflows to be calculated with reference to new benchmark i.e. with reference to fallback rate

  Valuers to use 'Adjusted MIFOR' for discounting rupee cashflows on notional amount from the derivative contract.

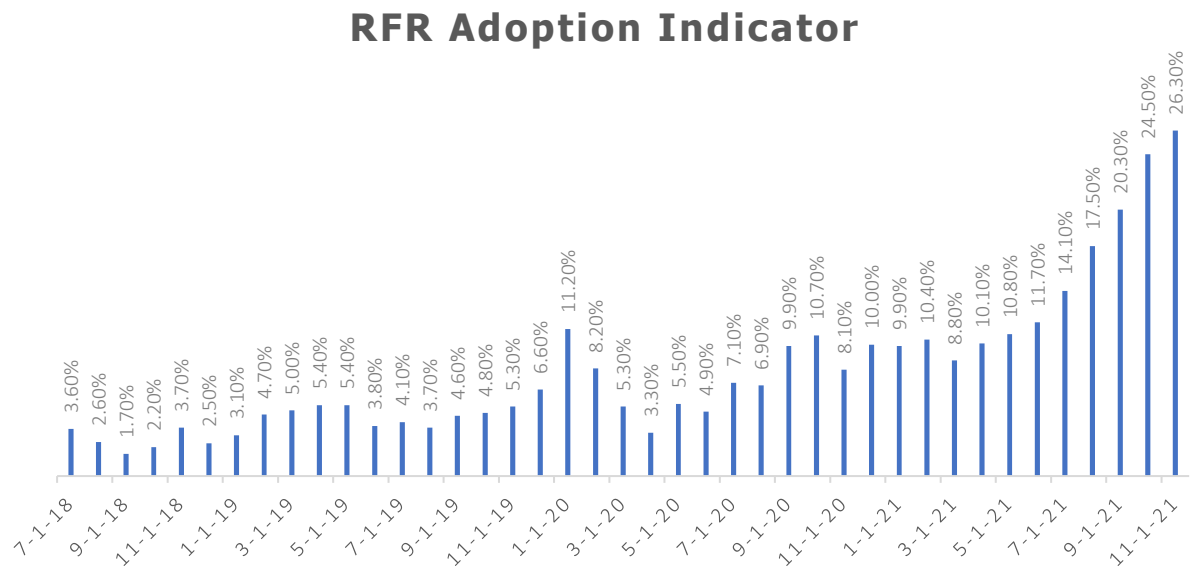
- Fallback rate is not mentioned in the contract
  Both parties need to renegotiate the contract as these 30 US Dollar settings will not be published going forward.

  It is technically not possible to identify fair value of these contracts as cashflows of these contracts cannot be reasonably identified in absence of published reference interest rate.

iii) Contracts maturing beyond 30.06.2023

There is a challenge to interpret these contracts as LIBOR curves will not be available beyond 30th June, 2023. It is advisable that valuers recommend their clients to renegotiate these contracts.

13. RFR Adoption Indicator – Assessment of Liquidity



Above chart[5] represents adoption of RFR in new derivative contracts in 6 currencies - USD, EUR, JPY, GBP, AUD and CHF. You can observe that November, 2021 reported 26.03% of the contracts entered in RFR i.e. Non-LIBOR reference rate. As a valuer, critical issue for discussion is liquidity of Non-Libor derivative contracts. Ind AS 113 requires assessment of 'active market'. On the basis of north east trend from the above chart, valuer may reasonably assume that liquidity in alternative risk-free rates (RFRs) is increasing.

[5] Source: https://rfr.clarusft.com

14. Adjusted MIFOR & Modified MIFOR

The Mumbai Interbank Forward Offer Rate (MIFOR) is the rate that Indian banks use as a benchmark for setting prices on forward-rate agreements and derivatives. It is a combination of the London Interbank Offered Rate (LIBOR) and a forward premium derived from Indian forex markets.

Historically, MIFOR has been calculated as follows:

MIFOR = ((1 + LIBOR * No of days / 36000) * (1+ USD/INR annualized forwards (in %) * No of days / 36500) - 1) * 36500 / No of days

With the cessation of LIBOR, MIFOR cannot be used on as is basis. Consequently, for legacy contracts with fallback rate, Adjusted Mifor is to be used for fair value calculations. Adjusted Mifor is calculated as follows:

The Adjusted MIFOR[6] is the MIFOR fallback rate and will be used for referencing the legacy contracts entered into for the MIFOR Curve. Adjusted MIFOR (MIFOR Fallback) Curve are computed using the USD/INR Rolling Forward Premia Curve and the USD LIBOR All- in-Fallback Rate (Calculated from the SOFR compounded in arrears & the 5 years historical median spreads between the respective tenors of SOFR and LIBOR calculated as per the ISDA Rule Book provided by Bloomberg). The FBIL Forward Premia Curve is a transaction-based benchmark computed from swap pairs of Cash-Tom and Spot-Forward trades in USD/INR pair reported to CCIL for settlement. The All-in-Fallback Rate consists of two components, namely, the Adjusted SOFR and the Spread Adjustment Value. Since the All-in-Fallback Rate is computed and published in arrears, the Adjusted MIFOR Curve for the relevant tenors is to be published in arrears.

The Modified MIFOR Curve has replaced the MIFOR curve for new contracts i.e. contract post 31st December, 2021. The Modified MIFOR Curve is computed by combining the Forward Premia Curve and the Adjusted SOFR Rate published by the Bloomberg Index Services Limited (BISL). The FBIL Forward Premia Curve is a transaction-based benchmark computed from swap pairs of USD/INR Cash-Tom and Spot-Forward trades reported to CCIL for settlement.

[6] Source: https://www.fbil.org.in

The Adjusted SOFR, is the overnight SOFR compounded in arrears for the applicable tenor using the methodology approved by the Benchmark Administrator. Since the Adjusted SOFR is published in arrears, the FBIL Modified MIFOR Curve for the relevant tenors will also be published by FBIL in arrears.

15. Impact on Financial Reporting (Ind AS)

Financial Liabilities are usually classified and measured at Amortized Cost. Financial Assets are classified on the basis of contractual cash flow test and business objective test either as at Amortised Cost, at Fair Value Through Profit or Loss, or at Fair Value Through Other Comprehensive Income. Derivatives are classified and measured at Fair Value Through Profit or Loss except for derivatives identified in effective cash flow hedges.

Consequent to LIBOR transition, some LIBOR reference contracts may undergo a modification. As a practical expedient, Companies (Indian Accounting Standard Amendment) Rules, 2021 allowed entities not to account for such modification through statement of profit & loss. Instead, rules allowed continuation of historical balances along with adjustment to effective interest rates.

16. Eight Step guide to LIBOR Transition

Valuers are expected to review the LIBOR transition into alternative reference rates. Following is the recommendatory 8 step approach to achieve successful transition in valuation practice related to derivative valuations.

Step 1. Understand the LIBOR transition process and how change is likely to impact financial instruments under valuation

Step 2. Analyse client's exposure to LIBOR

Step 3. Determine & address the impact that transition will likely have on your internal valuation process and valuation modelling

Step 4. Determine the availability of access to relevant database

Step 5. Analyse the impact on treasury and risk management including potential impact on effectiveness of hedge instruments

Step 6. Familiarise yourself with RFR contracts

Step 7. Engage with clients

Step 8. Educate employees

Step 1 **Understand the LIBOR transition process and how change is likely to impact financial instruments under valuation**
1. Obtain an understanding of transition and how change is likely to impact financial instruments under valuation 2. Get the knowledge of Alternate Risk-Free Rate as a replacement to existing LIBOR 3. Assess the impacted financial instruments/ markets that you and your clients work in 4. Engage with clients to understand their perspective on adopting/ facing the change

Step 2 **Analyse client's exposure to LIBOR**
1. Approach client to conduct entity wide assessment to identify LIBOR exposure client currently holds 2. Inspect critical elements of each contract such as – asset class, tenor, and maturity 3. Check whether client is switching some of its contracts from LIBOR to alternative reference rates. 4. Verify exposures in various trade finances, project finances, capital finances through FOREX debt funding and related derivative instruments etc.

Step 3 **Determine & address the impact that transition will likely have on your internal valuation process and valuation modelling**
1. Verify processes involving extensive use of LIBOR as an input 2. Analyse requirement of revision in the process/ calculation upon replacement of LIBOR 3. Check necessity of new processes/ calculations to supplement shift to new synthetic rates/ RFR

Step 4 **Determine the availability of access to relevant database**
1. Check availability of access to alternate reference rates (forward looking similar to LIBOR or backward looking such as SOFR) 2. Analyse requirement of any synthetic calculations to match maturities 3. Verify requirement of any database (may be on subscription basis) to fulfil valuation input requirements

Step 5 **Analyse the impact on treasury and risk management including potential impact on effectiveness of hedge instruments**
1. Observe the negotiation process between client and a banker 2. Review modification of cashflows on account of renewed contract 3. Validate the continuation of hedge effectiveness 4. Update the hedge documentation

Step 6 Familiarise yourself with RFR contracts
1. Identify tenor of the contract 2. Observe base rate and spreads 3. Verify whether Continued LIBOR reference contracts belong to 30 US Dollar settings or 5 US Dollar Settings 4. Observe other key inputs such as – effective date, maturity date, fixed/ floating rate, settlement dates, payment tranches, and rationale of the transaction

Step 7 Engage with clients
1. Educate client on LIBOR transition 2. Explain identified LIBOR Exposure and its potential impact on treasury management and valuations 3. Help client better prepared for contract modifications 4. Facilitate timely renewal and alternation of derivative contracts

Step 8 Educate Employees
1. Explain renewed inputs related to adjusted and modified MIFOR 2. Research 'additional paragraphs and commentary' necessary to be added in valuation reports 3. Help employees correctly identify contracts needing updated valuation approach – adjustment for less liquidity for RFR contract may be necessary in short term 4. Educate team members on Ind AS 109 amendments resulting in no gain or loss in profit or loss but revision in effective interest rate on account of contract modification

17. Potential Disclosures in Valuation Reports/ Annual Financial Statements

i) **Valuation Risk** – In cases of non-alignment of fallback provisions of commercially linked positions (for example loan i.e., non derivative has fallback provisions different from fall back provisions in the commercially aligned derivative contract). Also, for those contracts which continue to rely on 5 US settings for which rates will be published until June, 2023, valuation may not represent a value in 'liquid market'.

ii) **Hedging Risk** – Comment on effectiveness of the existing hedge arrangement is necessary.

iii) **Operational Risk** – how management has responded to LIBOR Cessation and how system updates and access to new RFRs have been achieved can be disclosed.

iv) **Tax Risk** – Management may disclose the tax risk arising on account of shift from LIBOR to ARR.

Valuation Standards Board

and

ICAI Registered Valuers Organisation

The Institute of Chartered Accountants of India

(Setup by an Act of Parliament)

New Delhi