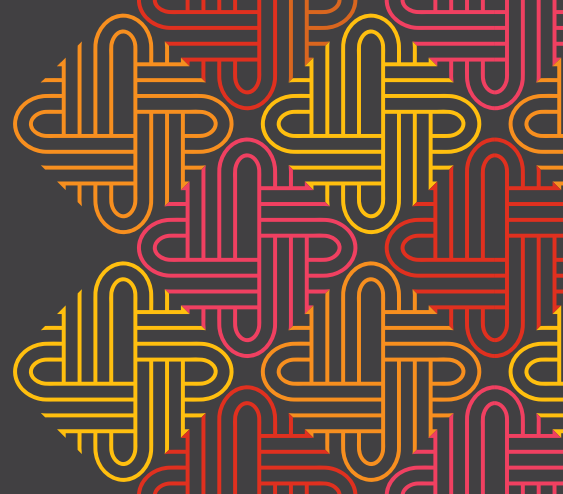


In Brief: Negative interest rates, not just for banks!



At a glance

A prolonged period of very low interest rates in New Zealand is starting to surface some interesting (and unique) accounting issues. These issues don't just impact banks, all borrowers and lenders could be impacted. Given the potential complexities this In Brief takes a closer look at the implications of potential negative interest rates.

What's the issue?

While the Reserve Bank of New Zealand (RBNZ) held the Official Cash Rate (OCR) at 0.25% at the latest Monetary Policy Committee meeting, and made no amendments to its current bond-buying programme, it continued to set the stage for additional monetary stimulus - openly maintaining a 'least regrets' approach.

One policy the RBNZ is currently considering is a negative OCR, expected to be enacted in early 2021.

While this seems simple at face value, it involves considerable effort to ready financial systems and think through the potential accounting implications. Our expectation is that this will impact almost all entities that borrow through banks and manage their interest rate exposures.

Specifically, there are risks that it will actually increase interest costs and create volatility in the financial statements under IFRS. Over the next few pages, we will consider some of the potential accounting implications of negative interest rates in this In Brief.

Impact on hedging

Entities commonly use derivatives to hedge risk exposures such as interest rate risk. It is important to take a closer look to understand any potential effects that negative interest rates could have on the hedge relationship.

Let's consider a cash flow hedge scenario. The hedged item is debt issued at a floating rate (the debt), which contains a zero percent floor; i.e. the interest rate an entity pays cannot go below zero (see discussion of embedded derivatives that follows). The debt was issued when interest rates were not negative and the floor is not accounted for separately. The hedging instrument is an interest rate swap (IRS), which does not contain an equivalent embedded zero percent floor, i.e. the interest rate in the IRS can go below zero.

Therefore a mismatch arises when interest rates go negative, because the interest cash flows arising from the debt are no longer offset by those of the IRS. This results in hedge ineffectiveness. An entity needs to assess whether the level of ineffectiveness would preclude continuation of hedge accounting. If hedge accounting is discontinued, subsequent fair value changes of the IRS would be accounted for in profit or loss, resulting in volatility in the income statement.

Embedded derivatives - zero percent floors

Many debt instruments including bank debt and bonds commonly include 'embedded' features. A typical example would be a zero percent floor, which is a feature that limits the amount of interest to be paid/received to a floor of zero percent. That is, no negative cash flows arise on the loan.

These floors are commonly found in floating rate loans (that is, loans bearing a benchmark rate, such as BKBM, plus a credit spread).

This feature appears in many debt agreements and historically, in a 'normal' interest rate environment, is not seen as a significant feature for the borrower or the lender. The assumption has been that the feature is unlikely to be relevant and cash flows of the arrangement will not be modified because of it. This means that the 'floor' was assessed as 'closely related' to the host instrument at inception of the loan.

An entity is required under IFRS 9 to assess whether an embedded floor is closely related (or not) to the loan. If not closely related, it must be accounted for separately from the loan at fair value through profit or loss, as if it was a stand-alone derivative, introducing volatility to the income statement. The closely related assessment requires an entity, at inception of the instrument, to compare the embedded floor to the corresponding market rate. The lower interest rates are, the more important this assessment becomes.

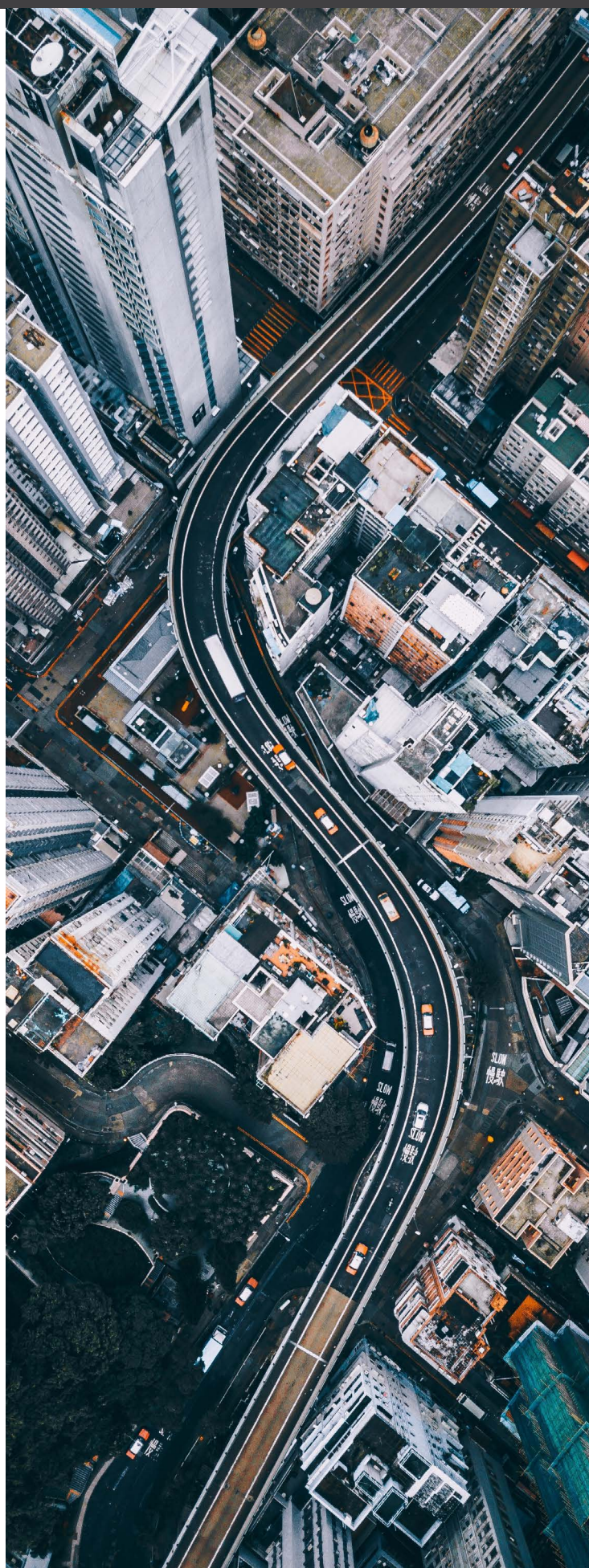
Different views have been expressed on which market rate should be used for the purposes of this assessment. Should it be the benchmark rate or should it be the benchmark rate plus the credit spread. If the credit spread is not included, it is likely that more embedded zero percent floors would be accounted for separately when the interest rates are negative.

Most companies, in practice, have used the benchmark rate plus the credit spread. Thus, few companies have historically separated and accounted for the embedded zero floor derivative.

Meeting SPPI criteria

IFRS 9 guidance is clear that in extreme economic circumstances, interest can be negative and this is not incompatible with the SPPI criteria. For example, the holder of a financial asset, either explicitly or implicitly, pays for the deposit of its money, and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs.

Therefore a negative interest rate environment should not, in isolation, result in changes to the classification of financial assets.



Impact on the Expected Credit Loss (ECL) model

IFRS 9 defines credit loss as the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive, discounted at the original effective interest rate (EIR). The standard is clear that this includes negative cash flows and a negative EIR. Where the interest rate on a loan is negative and amounts are settled net on default, the ECL calculation should include negative interest cash flows when determining cash shortfalls; and be discounted using the negative original effective interest rate.

Ability to incorporate negative interest rates when modelling ECL under the general impairment approach will be particularly important for banks and other financial institutions.

Estimation of discount rates

Insurance contracts

Negative interest rates also matter for instruments with characteristics similar to those of insurance contracts. Our view is that the entity should use negative rates for discounting, even if this results in the present value of the payments exceeding the nominal amount. The use of a 0% floor is not appropriate.

Defined benefit plans

IAS 19 specifies that the discount rate used to calculate the defined benefit obligation (DBO) should be determined as at the reporting date by reference to market yields on high-quality corporate bonds with the same term as the pension obligations. IAS 19 does not explicitly state whether a DBO should be calculated using negative discount rates, but this is implied given the reference to the market yields.

Other areas

There are a number of other areas of accounting that require use of discount rates and hence may be impacted by negative interest rates. These include provisions, leases, share based payments and significant financing components resulting from contracts with customers.

The first step in understanding the impact of the negative interest rates is to understand what specific guidance each individual standard has on the topic. For example, if a standard requires a risk-free rate as a starting point and it is negative then maybe that's the rate that an entity has to use. Given that more often than not there will be nothing specific in the standards on this topic, there might be more than one way of coming at the question and that will make disclosure of the policy applied very important.

Presentation considerations

IAS 1 requires an entity to present revenue, separately presenting interest revenue calculated using the effective interest method. In addition, IFRS 15 states that an entity should present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income.

As a result, an entity could present negative interest as a separate line item on the face of the income statement either within 'net finance costs' (being finance income, finance costs and negative interest) or as an other expense category. It could also be included within finance costs.

Negative effective interest arising on a financial liability is a gross inflow and should be presented within interest income or other income. Negative interest income or expense could be presented separately on the face of the income statement or disclosed separately in the notes to the financial statements. Once management has selected a particular presentation, they should apply it consistently.

Need more information?

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