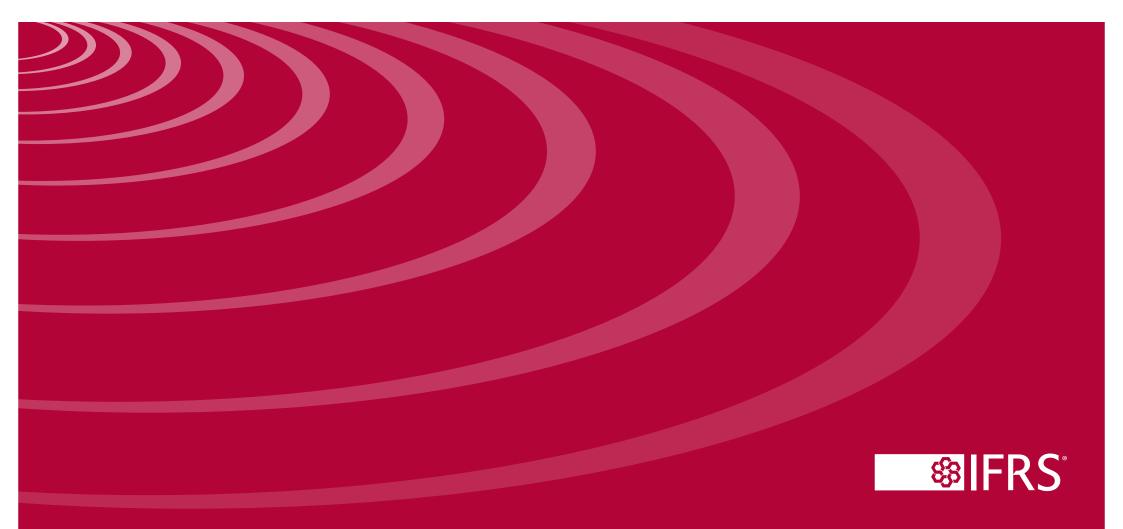
IFRS<sup>®</sup> Standards Project Summary

### Interest Rate Benchmark Reform—Phase 2 Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16



## Background

#### What is interest rate benchmark reform?

Interest rate benchmarks play an important role in global financial markets and index a variety of financial products worth trillions of dollars, including mortgages and derivatives.

In 2014 the Financial Stability Board recommended the reform of specified major interest rate benchmarks such as interbank offered rates (IBORs). Since then, public authorities in many jurisdictions have taken steps to reform interest rate benchmarks. Authorities have increasingly encouraged market participants to ensure timely progress towards the reform, including the replacement of interest rate benchmarks with alternative, nearly risk-free interest rates that are based to a greater extent on transaction data (alternative benchmark rates).

The progress towards interest rate benchmark reform (the reform) follows the general expectation that some major interest rate benchmarks will cease to be published by the end of 2021.

#### How has the Board responded to the reform?

In September 2019 the International Accounting Standards Board (Board) amended IFRS 9 *Financial Instruments*, IAS 39 *Financial Instruments*: *Recognition and Measurement* and IFRS 7 *Financial Instruments*: *Disclosures* to address as a priority issues affecting financial reporting in the period before the reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate (Phase 1 amendments). These Phase 1 amendments provided temporary exceptions to specific hedge accounting requirements because of the uncertainty arising from the reform.

After issuing the Phase 1 amendments, the Board commenced Phase 2 of its project, and in August 2020 issued further amendments to IFRS Standards, concluding its work in response to the reform. The Phase 2 amendments address issues that might affect financial reporting during the reform of an interest rate benchmark, including the effects of changes to contractual cash flows or hedging relationships arising from the replacement of an interest rate benchmark with an alternative benchmark rate (replacement issues).

<sup>1</sup> The report is available at <a href="http://www.fsb.org/wp-content/uploads/r\_140722.pdf">http://www.fsb.org/wp-content/uploads/r\_140722.pdf</a>

<sup>2</sup> The Phase 1 project summary is available at https://cdn.ifrs.org/-/media/project/ibor-reform/interest-rate-benchmark-reform-project-summary.pdf

### Overview of the Phase 2 amendments

The objectives of the Phase 2 amendments are to:

- support companies in applying IFRS Standards when changes are made to contractual cash flows or hedging relationships because of the reform; and
- assist companies in providing useful information to users of financial statements.

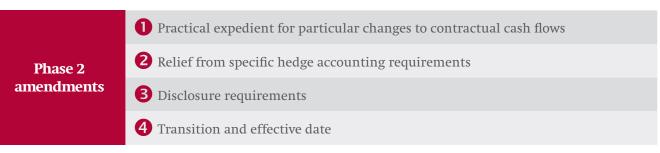
In Phase 2 of its project, the Board amended requirements in IFRS 9, IAS 39, IFRS 7, IFRS 4 *Insurance Contracts* and IFRS 16 *Leases* relating to:

- changes in the basis for determining contractual cash flows of financial assets, financial liabilities and lease liabilities;
- hedge accounting; and
- disclosures.

The Phase 2 amendments apply only to changes required by the reform to financial instruments and hedging relationships. The amendments address the effects of the reform on a company's financial statements that arise when, for example, an interest rate benchmark used to calculate interest on a financial asset is replaced with an alternative benchmark rate.

Given the global use of such benchmark rates for many types of financial instruments, the Board expects the amendments to affect many companies.

### Key areas addressed by the Phase 2 amendments:



# Practical expedient for changes to contractual cash flows

### What is the issue?

The replacement or reform of an interest rate benchmark is likely to change the basis for determining the contractual cash flows of a financial asset or financial liability.

Changing the basis for determining the contractual cash flows of a financial asset or financial liability could entail:

- (a) amending the contractual terms of a financial asset or financial liability to replace the interest rate benchmark;
- (b) altering the method for calculating the interest rate benchmark without amending the contractual terms of the financial instrument; or
- (c) triggering the activation of an existing contractual term such as a fallback clause.<sup>3</sup>

In the absence of any relief from the requirements in IFRS 9, a company would assess whether changing the basis for determining contractual cash flows would result in the derecognition of the financial instrument. Even if the change results in no derecognition, a gain or loss would be immediately recognised in profit or loss. This would be determined by recalculating the carrying amount of the financial instrument using the original effective interest rate to discount the revised contractual cash flows.

The Board considered that such an outcome would not necessarily provide useful information to users of financial statements.

### Amendments

• The Board amended IFRS 9 to add a practical expedient that enables a company to account for a change in the contractual cash flows that are required by the reform by updating the effective interest rate to reflect, for example, the change in an interest rate benchmark from IBOR to an alternative benchmark rate.

For the purpose of the Phase 2 amendments, a change in the basis for determining the contractual cash flows is required by the reform only if:

- (a) the change is necessary as a direct consequence of the reform; and
- (b) the new basis for determining the contractual cash flows is economically equivalent to the previous basis.

continued ...

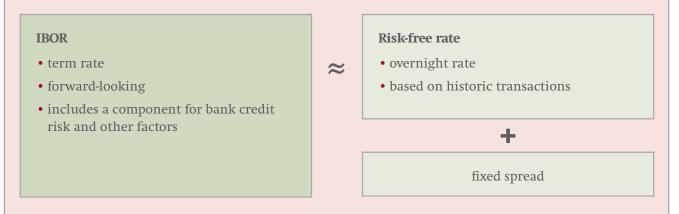
<sup>3</sup> For example, a fallback clause could set out how to identify a replacement rate if an interest rate benchmark is no longer available.

# Practical expedient for changes to contractual cash flows ... continued

- If a company makes any changes to the contractual cash flows beyond those required by the reform, the company would:
- first apply the practical expedient to the changes required by the reform; and
- then apply the applicable requirements in IFRS 9 to any other changes.
- To enable insurers and lessees to apply a similar practical expedient in relation to their financial instruments and leases respectively, the Board also amended IFRS 4 and IFRS 16.

#### An example of an economically equivalent change

- A company replaces IBOR with a nearly risk-free alternative benchmark rate.
- The risk-free rate is lower than IBOR and, to account for the economic basis difference, a fixed spread is added to the risk-free rate.
- Such a change in the benchmark rate, with the addition of a fixed spread adjustment, is an example of a change that would meet the Board's economically equivalent condition.



## 2 Relief from specific hedge accounting requirements

### What is the issue?

IFRS 9 and IAS 39 set out the criteria for a company to qualify for hedge accounting and require the company to document specific information about the hedging relationship when the hedge is created. The required documentation includes identification of the hedged item, the nature of the risk being hedged, the hedging instrument and how the entity will assess hedge effectiveness.

When a company applies the hedge accounting requirements in IFRS 9 and IAS 39, changes to the basis for determining the contractual cash flows of a financial instrument designated in a hedging relationship would affect the designation of such a hedging relationship.

Without relief from specific requirements in IFRS 9 and IAS 39, companies would be required to discontinue hedge accounting solely due to changes required by the reform.

The amendments enable (and require) companies to continue hedge accounting in circumstances when changes to hedged items and hedging instruments arise as a result of changes required by the reform.

### Amendments

Companies are required to amend their hedging relationships to reflect:

- designating an alternative benchmark rate as the hedged risk;
- changing the description of the hedged item, including the designated portion, or of the hedging instrument; or
- changing the description of how the entity would assess hedge effectiveness (IAS 39 only).

Because a company would make changes required by the reform to the hedged items and hedging instruments at various times, companies may need to amend a hedging relationship more than once.

The Board also provided relief from the hedge accounting requirements in IFRS 9 and IAS 39 for:

Amounts accumulated	Separately
in the cash flow	identifiable
hedge reserve	requirement
Groups of items	Retrospective
designated as	effectiveness assessment
hedged items	(IAS 39 only)

The amended hedging relationship is still required to meet all other qualifying criteria for the company to apply hedge accounting. Also, hedged items and hedging instruments are measured in accordance with IFRS 9 and IAS 39.

A company would include any changes in the fair value of the hedged item or the hedging instrument in the recognition and measurement of hedge ineffectiveness in the financial statements. Therefore, the measurement of hedge effectiveness is consistent with the Board's decision to account for changes required by the reform as the continuation of the hedging relationship, and reflects the economic effects of the reform.

	What is the problem?	Phase 2 Amendments
Amounts accumulated in cash flow hedge reserve	<ul><li>IFRS 9 and IAS 39 require the cash flow hedge reserve to be reclassified to profit or loss when the hedged cash flows are no longer highly probable.</li><li>A company reclassifies to profit or loss the amount accumulated in the cash flow hedge reserve in the period that the hedged cash flows affect profit or loss. When the company changes the description of the hedged item, the IBOR-hedged cash flows on which the cash flow hedge reserve was based will no longer affect profit or loss.</li></ul>	When the company changes the description of the hedged item to reflect changes required by the reform, the amount accumulated in the cash flow hedge reserve is deemed to be based on the alternative benchmark rate. Therefore, the company reclassifies the cash flow hedge reserve to profit or loss only when the cash flows of the amended hedged item affect profit or loss. The same relief is applied to the amount in the cash flow hedge reserve relating to hedging relationships that have been discontinued.
Groups of items	Companies apply the qualifying criteria in IFRS 9 and IAS 39 for groups of items to be eligible hedged items to the hedging relationship in its entirety. For groups of items designated as hedged items in a fair value or cash flow hedge, the hedged items could consist of items that refer to IBOR as well as items that refer to the new alternative benchmark rate. Therefore, a company could not amend the description of the hedged risk or the hedged item to refer to only an alternative benchmark rate for the group as a whole.	Companies allocate hedged items to subgroups within the hedging relationship based on the benchmark rate being hedged. The qualifying criteria for hedged items in IFRS 9 and IAS 39 are separately applied to each subgroup.

	What is the problem?	Phase 2 Amendments	
Separately identifiable requirements	IFRS 9 and IAS 39 require contractually or non-contractually specified risk components designated in a hedging relationship to be separately identifiable and reliably measurable. When a company amends hedging relationships or designates new hedging relationships to reflect changes required by the reform, an alternative benchmark rate designated as a non-contractually specified risk component may fail to meet the separately identifiable requirement if the particular market for an alternative benchmark rate has not yet sufficiently developed.	If an alternative benchmark rate designated as a non-contractually specified risk component fails to meet the separately identifiable requirement at the date it is designated, it will be deemed to be separately identifiable if a company has a reasonable expectation that the rate will meet the requirement within 24 months from the date it is designated. The 24-month period applies to each rate from the date a company designates an alternative benchmark rate for the first time.	
Retrospective effectiveness assessment (IAS 39 only)	When a company ceases to apply the Phase 1 relief from the retrospective assessment requirement, the hedging relationship could fail the retrospective effectiveness assessment because of the build-up of ineffectiveness caused by the uncertainty arising from the reform. This will especially affect hedging relationships in which hedge effectiveness is assessed on a cumulative basis.	For the purpose of the retrospective effectiveness assessment only, companies are permitted to reset to zero the cumulative fair value changes of the hedged item and hedging instrument when ceasing to apply the Phase 1 relief. This choice is available for each hedging relationship.	

## **3** Disclosure requirements

### What is the issue?

Before the Board issued these amendments, IFRS 7 required a company to disclose information that would reflect some changes resulting from the reform but might have failed to capture some other useful information.

### Amendments

The Board amended IFRS 7 to require a company to make additional disclosures in its financial statements so that investors can better understand the reform's effects on that company.

The additional disclosure requirements are designed to balance the benefits to investors with a company's costs to provide the additional information. These objective-based disclosure requirements limit the costs of applying the amendments by allowing companies to choose their own methods for disclosing the required information.

#### Objectives of the disclosures

Companies are required to provide disclosures that enable investors to understand:

- the nature and extent of risks to which the company is exposed arising from financial instruments that are subject to interest rate benchmark reform, and how the company manages those risks; and
- the company's progress in completing the transition to alternative benchmark rates, and how the entity is managing that transition.

### Achieving the objectives

A company is required to disclose:

- (a) how it is managing the transition to alternative benchmark rates, its progress at the reporting date and the risks to which it is exposed arising from financial instruments as a result of the transition.
- (b) quantitative information about non-derivative financial assets, non-derivative financial liabilities and derivatives, each shown separately, that have yet to transition to an alternative benchmark rate as at the end of the reporting period. The company is required to disaggregate this quantitative information by significant interest rate benchmark.
- (c) a description of any changes to the company's risk management strategy arising from the risks in (a).

### **4** Transition and effective date

### Transition

The amendments apply retrospectively, but companies are not required to restate comparative information.

Additionally, a company is required to reinstate a discontinued hedging relationship if, and only if:

- the company discontinued the hedging relationship solely because of changes required by the reform; and
- at the date of initial application of the amendments, that discontinued hedging relationship meets all qualifying criteria for hedge accounting.

### Effective date

The amendments apply for annual periods beginning on or after 1 January 2021. Earlier application is permitted.

The short period between the Board issuing the amendments and their effective date reflects the urgency of the changes.

Companies are required to apply all the amendments except for the amendment that permits, rather than requires, a company to reset cumulative fair values to zero for the purpose of performing the retrospective effectiveness assessment.

	Which IFRS Standards are amended?				
Amendments	<b>IFRS 9</b> Financial Instruments	IAS 39 Financial Instruments: Recognition and Measurement	IFRS 7 Financial Instruments: Disclosures	IFRS 4 Insurance Contracts	IFRS 16 Leases
1. Practical expedient for particular changes in contractual cash flows	$\checkmark$			$\checkmark$	~
2. Relief from specific hedge accounting requirements	$\checkmark$	$\checkmark$			
3. Disclosure requirements			$\checkmark$		

### Important information

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### Further information

The Basis for Conclusions on the Interest Rate Benchmark Reform—Phase 2, which amends IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16, analyses the considerations of the Board when developing these amendments including comprehensive analysis of the feedback on the proposals that preceded the amendments and how the Board responded to that feedback.

### Stay informed

To stay up to date with the latest developments and to sign up for email alerts about the project, please visit the project homepage on <a href="https://www.ifrs.org/projects/work-plan/ibor-reform-and-its-effects-on-financial-reporting-phase-2/">https://www.ifrs.org/projects/work-plan/ibor-reform-and-its-effects-on-financial-reporting-phase-2/</a>

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