

STAFF PAPER

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| Project | IBOR Reform and its Effects on Financial Reporting | | |
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| Paper topic | Issues leading up to IBOR reform | | |
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Introduction

1. At its December 2018 meeting, the Board decided to add to its standard-setting programme the *IBOR Reform and its Effects on Financial Reporting* project to assess the effects on financial reporting of the potential discontinuation of IBOR. Following the discussion around the staff research findings at the December 2018 Board meeting, the purpose of this paper is to present the staff analysis and the proposed amendments to IFRS Standards for specific issues affecting financial reporting leading up to IBOR reform.
2. This paper is structured as follows:
 - (a) Summary of staff recommendations (paragraph 3);
 - (b) Background (paragraphs 4 – 12);
 - (c) Highly probable requirement (paragraphs 13 – 35);
 - (d) Prospective assessments (paragraphs 36 – 61);
 - (e) Risk components (paragraphs 62 – 94);
 - (f) End of the proposed relief (paragraphs 95 – 104);
 - (g) Disclosures (paragraphs 105 – 108);
 - (h) Effective date (paragraphs 109 – 112); and

- (i) High-level project timeline (paragraphs 113 – 115).

Summary of staff recommendations

3. In this paper the staff recommend that:

- (a) IFRS 9 and IAS 39 should be amended to provide relief from the effects of IBOR reform uncertainties on the highly probable requirement;
- (b) IAS 39 and IFRS 9 should be amended to provide relief from the effects of IBOR reform uncertainties on the prospective assessments¹;
- (c) the Board should not amend the hedge accounting model in IFRS 9 and IAS 39 to provide relief for designation of risk components that are not separately identifiable;
- (d) entities should stop applying the proposed relief when the earlier of the following occurs: i) the designated IBOR financial instrument is contractually amended to replace IBOR for the alternative RFR; or ii) the hedging relationship terminates. In addition, entities are not permitted to apply the proposed relief for hedging relationships designated after the RFR is separately identifiable;
- (e) entities should provide specific disclosures about the extent to which they are applying the proposed relief; and
- (f) entities should apply the proposed amendments retrospectively. The proposed effective date of the amendments is 1 January 2020 with earlier application permitted.

¹ In this paper, the requirements in paragraph 6.4.1(c)(i) of IFRS 9 (ie the existence of an economic relationship) and paragraph AG105(a) of IAS 39 (ie whether the hedge is expected to be highly effective) are collectively referred to as ‘prospective assessments’.

Background

4. As discussed at the June 2018 Board meeting, recent developments have brought into question the long-term viability of some interbank offered rates (IBOR).² In some jurisdictions, there is already a clear steer towards replacing them by alternative, nearly risk-free rates (RFR), which are based, to a higher extent, on transaction data.
5. At its December 2018 meeting, the Board decided to divide the *IBOR Reform and its Effects on Financial Reporting* project into two phases and address the issues arising in the first phase as a priority. The first phase will focus on issues affecting financial reporting leading up to IBOR reform. These issues are more urgent because they might affect financial reporting before IBOR reform is enacted. The second phase of the project will focus on issues that affect financial reporting when IBOR reform is enacted. With respect to the second-phase issues, the staff note that there is an ongoing debate about how market participants will approach some key issues related to amendment of legacy positions and whether value transfers will occur as a result. These amendments can vary significantly across jurisdictions, product types and agreements. As a result, the staff will need to monitor further developments in this area so that, as more information become available, the staff will be able to provide a comprehensive assessment of the potential implications of IBOR reform on these second-phase issues. This paper covers issues arising in the first phase of the project only.
6. At the December 2018 Board meeting, the staff noted that some areas in hedge accounting that require forward-looking analyses might be impacted by uncertainties arising from IBOR reform. These include the ‘highly probable’ requirement for forecast transactions designated as hedged items, and the existence of an economic relationship, according to *IFRS 9: Financial Instruments* (IFRS 9), or expectation that the hedge will be highly effective in achieving offsetting, as per *IAS 39: Financial Instruments: Recognition and Measurement*

² As noted in the June 2018 Agenda Paper *Research project proposal*, interbank offered rates (IBOR) are interest rates that represent the cost of obtaining unsecured funding, in a particular combination of currency and maturity, and in a particular interbank term lending market. The most widely used of these reference rates is the London Interbank Offered Rate (LIBOR). Other examples of IBOR are the Euro Interbank Offered Rate (EURIBOR) and the Tokyo Interbank Offered Rate (TIBOR).

(IAS 39), which are, by nature, forward-looking assertions. These assertions are part of the set of qualifying criteria an entity must comply with in order to apply hedge accounting. The staff highlight that these specific forward-looking assertions do not change the actual results of a hedge and thus do not affect measurement of the hedging instrument and hedged item. Instead, these assertions reflect an entity's expectation that, going forward, the hedging relationship will meet these specific criteria to qualify for hedge accounting.

7. The proposals discussed in this paper aim to provide relief from the effects of IBOR reform uncertainties on the above forward-looking assertions required by IFRS 9 and IAS 39. As the specific conditions of IBOR reform develop and time to transition approaches, the fair value of designated hedging instruments and hedged items might be affected. This would represent the economics of such instruments that the staff think should be captured in financial reporting. Consequently, the proposals in this paper are designed accordingly. In other words, the economics of these instruments will be captured through measurement, which is not affected by the proposed relief discussed in this paper.
8. In addition, the staff note that some aspects of the IBOR reform might also impact the requirements for designation of some risk components as hedged items. These issues might affect financial reporting before IBOR reform is enacted as they could lead to discontinuation of hedge accounting and potentially preclude designation of new hedging relationships.
9. Failure to achieve or continue hedge accounting due to a major change in market structure, such as IBOR reform, was not contemplated when IFRS 9 and IAS 39 were written. In view of this, this paper provides further analysis on whether discontinuation of hedge accounting would provide useful information to users of financial statements when a hedging relationship fails the hedge accounting requirements noted in paragraph 10 due to uncertainties arising from IBOR reform.
10. In this paper, we discuss issues contemplated in the first phase of the project and recommend whether or not the Board should take any actions to address them. The discussion is segregated into the following areas in hedge accounting:
 - (a) Highly probable requirement (paragraphs 13 – 35);

- (b) Prospective assessments (paragraphs 36 – 61); and
 - (c) Risk components (paragraphs 62 – 94).
11. As the above hedge accounting issues arise in a context of a market wide reform of benchmark interest rates, this paper focuses on hedges of interest rate risk only. Consequently, the solutions proposed in this paper only apply to hedges of interest rate risk. In addition, given hedge accounting is optional, the application of the proposed relief is also optional.
12. As discussed at the December 2018 meeting, paragraph 7.2.21 of IFRS 9 states that when an entity first applies IFRS 9 it may choose to continue to apply the hedge accounting requirements of IAS 39 instead of those in IFRS 9. In addition, companies applying *IFRS 4: Insurance Contracts* and that meet certain conditions, may continue to apply IAS 39 for annual periods beginning before 1 January 2021 (or 1 January 2022 as tentatively decided by the Board at its November 2018 meeting). For these reasons, our analysis contemplates both IFRS 9 and IAS 39.

Highly probable requirement

13. According to paragraph 6.3.3 of IFRS 9 and paragraph 88(c) of IAS 39, when a forecast transaction is designated as a hedged item in a cash flow hedge, that transaction must be highly probable. When the hedged item is designated in terms of forecast IBOR cash flows and these cash flows will occur after IBOR reform, the question that follows is whether those forecast IBOR cash flows would meet the highly probable requirement because the underlying contracts will likely be amended at some point in the future to reflect a new benchmark RFR, as discussed at the December 2018 Board meeting.
14. The staff also highlight that, to meet the highly probable requirement, paragraphs F.3.10 and F.3.11 of the Implementation Guidance of IAS 39 states that an entity should identify and document a forecast transaction with sufficient specificity so that, when the transaction occurs, the entity is able to determine whether the transaction is the hedged transaction. The same guidance would apply to hedging relationships designated under IFRS 9 (paragraph BC6.95 of the Basis for

Conclusions of IFRS 9 states that not carrying forward the Implementation Guidance of IAS 39 did not mean that the Board had rejected that guidance).

15. In practice, hedging relationships are commonly designated whereby the IBOR component of a financial instrument is documented as the hedged risk. In this context, paragraph B6.3.11 of IFRS 9 states that, when designating a risk component as a hedged item, the hedge accounting requirements apply to that risk component in the same way as they apply to other hedged items that are not risk components. Consequently, given the requirement for specificity, it might be difficult to demonstrate, at some point in the future, that the designated IBOR cash flows are highly probable given the effects from IBOR reform. The staff note that, although the words in IFRS 9 and IAS 39 may be slightly different, both standards have the same requirements in this area.
16. As per paragraph 6.3.7 of IFRS 9 and paragraph 81 of IAS 39, an entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. Regardless of whether an entity designates the IBOR risk component of a floating-rate debt or the entire debt instrument as the hedged item, in both cases the uncertainties arising from IBOR reform could affect the highly probable requirement. Therefore, as uncertainty from IBOR reform increases and time to transition approaches, it could be argued that, at some point, these designated forecast cash flows will be no longer highly probable under IFRS 9 and IAS 39.

Accounting implications

17. Paragraph 6.5.6 of IFRS 9 and paragraph 101 of IAS 39 require an entity to discontinue hedge accounting prospectively when the hedging relationship ceases to meet the qualifying criteria, one of which is the highly probable requirement. In particular, if the hedged future cash flows are no longer expected to occur, paragraph 6.5.12(b) of IFRS 9 and paragraph 101(c) of IAS 39 state that an entity should discontinue hedge accounting for a cash flow hedge, and the amount accumulated in the cash flow hedge reserve should be immediately reclassified from the cash flow hedge reserve to profit or loss. In addition, going forward, this would also result in changes in fair value of derivatives that would otherwise

qualify for hedge accounting being recognised in profit or loss (instead of the cash flow hedge reserve in Other Comprehensive Income).

18. However, a forecast transaction that is no longer highly probable may still be expected to occur. In view of this, paragraph 6.5.12(a) of IFRS 9 and paragraph 101(b) of IAS 39 state that, if the hedged future cash flows are no longer highly probable but still expected to occur, the amount accumulated in the cash flow hedge reserve should remain in the cash flow hedge reserve until the future cash flows occur. When the future cash flows occur, that amount should be reclassified from the cash flow hedge reserve to profit or loss.
19. In this context, IBOR reform might also impact reclassification of the amount accumulated in the cash flow hedge reserve related to hedging relationships that have been discontinued. For example, assume a hedging relationship was discontinued because the counterparty to the derivative (hedging instrument) experienced a severe deterioration in its credit standing, as noted in paragraph 6.4.1(c)(ii) of IFRS 9. In this scenario, the amount accumulated in the cash flow hedge reserve would be reclassified to profit or loss when the hedged item occurs (ie it is not immediately reclassified). However, assuming the hedged item in this example was designated in terms of forecast IBOR cash flows beyond IBOR reform, if those cash flows become neither highly probable nor expected to occur due to IBOR reform, the amount accumulated in the cash flow hedge reserve would be immediately reclassified to profit or loss rather than reclassified to profit or loss when the hedged item occurs.
20. In the above example, deterioration of credit standing was used to illustrate a situation of failure to meet one of the hedge accounting qualifying criteria in IFRS 9. The same rationale would apply if a hedging relationship did not meet one of the qualifying criteria in IAS 39 (eg if the hedge was not highly effective throughout the financial reporting periods for which the hedge was designated, as required in paragraph 88(e) of IAS 39).

Types of hedging relationships that might be affected

21. To assess the accounting implications and potential solutions, the staff considered the population of hedging relationships in which the highly probable requirement

might be affected by uncertainties arising from IBOR reform. In particular, we considered the following types of hedges of interest rate risk:

- (a) *Existing IBOR hedges*: these include hedges of recognised IBOR-based instruments and forecast IBOR cash flows. For the purpose of this analysis, ‘existing’ hedges refer to hedging relationships designated before or as at the effective date of any potential amendments to IFRS 9 and IAS 39;
- (b) *New IBOR hedges*: similar to item (a) above, these include hedges of recognised IBOR-based instruments and forecast IBOR cash flows. For the purpose of this analysis, ‘new’ hedges refer to relationships designated after the effective date of any potential amendments to IFRS 9 and IAS 39; and
- (c) *New RFR hedges*: these refer to hedges of forecast RFR cash flows. For the purpose of this analysis, ‘new’ hedges refer to relationships designated after the effective date of any potential amendments to IFRS 9 and IAS 39.

22. As noted in paragraph 16, failing the highly probable requirement would affect existing hedges where forecast IBOR cash flows beyond IBOR reform have been designated as the hedged item. The same applies to new IBOR hedges (ie relationships designated after the effective date of any potential amendments to IFRS 9 and IAS 39 that the Board may consider), because these relationships might also be affected by uncertainties from IBOR reform.
23. Regarding new RFR hedges, as noted in the December 2018 Board meeting, while derivative markets could have a standardised protocol enacted, if agreed by all parties, to reduce the burden of re-negotiating outstanding contracts, the process of amending legacy positions in the cash markets is yet to be determined. Therefore, it might be possible that in some jurisdictions the RFR derivative market develops before the RFR cash markets. In this context, assuming entities use RFR forward start swaps to hedge a forecast RFR debt issuance, as the specific conditions for IBOR reform affecting the forecast RFR debt instrument remain uncertain (eg whether the forecast debt instrument will bear an overnight

RFR or a 3-month RFR), these forecast RFR cash flows might fail the highly probable requirement.

Staff analysis

24. As discussed at the December 2018 Board meeting, the staff think the guidance in IFRS 9 and IAS 39 provides an adequate basis to conclude an entity should discontinue hedge accounting when the designated forecasted cash flows are no longer highly probable. However, the replacement of IBOR will occur as a result of a market wide reform of benchmark RFR. More specifically, IBOR reform arises from a G20 request to the Financial Stability Board (FSB) to undertake a fundamental review of major interest rate benchmarks and develop plans for reform to ensure that these benchmarks are robust and appropriately used by market participants. Discontinuation of hedge accounting due to a major change in market structure, such as IBOR reform, was not contemplated during the development of IFRS 9 and IAS 39.
25. Failure to meet the highly probable requirement will have a significant impact on financial reporting and key accounting ratios for many IFRS preparers globally. This is because discontinuation of hedge accounting would result in reclassification of the cash flow hedge reserve to profit or loss, and derivatives that would otherwise qualify for hedge accounting purposes would be treated as trading derivatives going forward (ie measured at fair value through profit or loss).
26. The highly probable requirement ensures that changes in fair value of designated hedging instruments are recorded in the cash flow hedge reserve in Other Comprehensive Income only for those forecast transactions for which there is a high probability of occurrence. It plays an important role in ensuring the discipline around the application of hedge accounting. However, the scenario being considered, IBOR reform, is unprecedented and was not contemplated during the development of IFRS 9 and IAS 39. In this scenario, whilst interest cash flows are still going to occur, the specificity associated with these cash flows (ie whether they will be IBOR cash flows or RFR-based cash flows) is in question due to the reform. Given the accounting consequences, as outlined in paragraphs 17–19 above and the ubiquity of IBOR usage across the globe, the staff, on balance, is of

the view that the Board should consider amending IFRS 9 and IAS 39 to provide relief from the uncertainty arising from this narrow specific circumstance.

27. In view of this, the staff think it is appropriate to amend IFRS 9 and IAS 39 to provide relief from the effects of IBOR reform uncertainties on the highly probable requirement. This means that any potential amendments to the hedged item due to IBOR reform should not affect the highly probable requirement. More specifically, when assessing the likelihood that a forecast transaction will occur, an entity should consider the existing contractual terms if the highly probable assertion is based on the contractual terms of an existing contract (eg highly probable future IBOR cash flows associated with an existing floating rate liability). It should not consider possible amendments to such terms arising from IBOR reform. When the highly probable assertion is based on future transactions not recognised on the balance sheet, for example a future issuance of a floating rate debt instrument, potential amendments to the future contract due to IBOR reform should not affect the highly probable assertion for that forecast transaction. The proposed relief is optional and applies to all types of hedges of interest rate risk noted in paragraph 21 above.
28. In case the Board agrees with the staff recommendation, we think the proposed amendments to IFRS 9 and IAS 39 should clarify the Board's intention to provide relief from effects arising solely from IBOR reform uncertainties. In other words, if forecast cash flows fail the highly probable requirement due to reasons other than IBOR reform uncertainties, the proposed relief would not apply and thus those forecast cash flows would not be eligible as the hedged item in a hedging relationship under IFRS 9 and IAS 39. For example, this would be the case if a forecast transaction is considered no longer highly probable to occur due to changes in an entity's financial conditions. The staff think the proposed amendments should also make it clear that all other hedge accounting requirements must be applied as stipulated by IFRS 9 and IAS 39.³

³ The staff highlight that, in a similar situation in the past (June 2013), the Board considered the financial reporting effects arising from novations that result from new laws or regulations and decided to amend IAS 39 to provide relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument met certain criteria.

29. Consistent with the above, the staff would recommend that the proposed relief should also apply to hedging relationships that have been previously discontinued for reasons other than IBOR reform with an amount remaining in the cash flow hedge reserve. This is because, as noted in paragraph 19, uncertainties arising from IBOR reform might require immediate reclassification of the amount accumulated in the cash flow hedge reserve. Applying the relief would allow entities to continue reclassifying the amount accumulated in the cash flow hedge reserve to profit or loss in the same period or periods during which the hedged expected future cash flows affect profit or loss (see paragraph 6.5.11(d)(i) of IFRS 9 and paragraph 97 of IAS 39).

Illustrative example – highly probable requirement

30. To illustrate the application of the proposed amendments, assume an entity issues a 5-year floating-rate debt instrument, which pays interest quarterly at 3-month IBOR. The entity also enters into a 5-year interest rate swap under which it receives 3-month IBOR and pays a fixed rate of 4.0%. Assuming the relationship meets all the qualifying criteria for cash flow hedge accounting, the entity designates the forecast 3-month IBOR interest payments as the hedged item and the interest rate swap as the hedging instrument. In this scenario, the existing contractual obligation would typically support the assertion that the forecast IBOR interest payments are highly probable at inception of the hedging relationship. However, as IBOR reform approaches, there would be an increased probability that the debt instrument will be amended to reflect the alternative RFR and thus, at some point, the designated forecast IBOR interest payments would fail the highly probable requirement.
31. Applying the proposed relief would allow the entity to account for such hedging relationships as continuing relationships. In this example, because the hedging relationship would have failed the highly probable requirement solely due to uncertainties arising from IBOR reform, the entity would be able to disregard such effects when assessing the highly probable requirement until the debt instrument is amended to reflect the alternative RFR and such uncertainties are no longer present. If, for example, the entity expects to default on the debt instrument, then the entity would fail the highly probable requirement.

32. The period over which entities could apply such a relief is further discussed in paragraphs 95–104.

Staff recommendation

33. For the reasons stated in paragraphs 24 – 32, the staff are of the view that IFRS 9 and IAS 39 should be amended to provide relief from the effects of IBOR reform uncertainties on the highly probable requirement. This means that any potential amendments to the hedged item due to IBOR reform should not affect the highly probable requirement. More specifically, when assessing the likelihood that a forecast transaction will occur, an entity should consider the existing contractual terms of a recognised hedged item until uncertainties arising from IBOR reform are no longer present. Regarding unrecognised forecast transactions, potential amendments to underlying contracts due to IBOR reform should not affect the highly probable assertion for that forecast transaction.
34. In addition, the staff recommend that the same relief should apply to hedging relationships that have been previously discontinued for reasons other than IBOR reform with an amount remaining in the cash flow hedge reserve. Applying the relief would allow entities to continue reclassifying the amount accumulated in the cash flow hedge reserve to profit or loss in the same period or periods during which the hedged expected future cash flows affect profit or loss.
35. As noted in paragraph 6, uncertainties arising from IBOR reform might affect both the highly probable requirement and the prospective assessments required by IFRS 9 and IAS 39. Consequently, even if the Board agrees with the above staff recommendation to provide relief from the effects of IBOR reform uncertainties on the highly probable requirement, an entity could still fail the prospective assessments due to the same effects arising from IBOR reform. Hence, the staff think the decision with respect to the two requirements should be made together and accordingly this question is posed to the Board after the discussion on the prospective assessments.

Prospective assessments

36. Prospective assessments apply to both fair value and cash flow hedges. According to paragraph 6.4.1(c)(i) of IFRS 9, a hedging relationship qualifies for hedge accounting only if there is an economic relationship between the hedged item and the hedging instrument. In this context, paragraph B6.4.4 of IFRS 9 notes that an economic relationship exists when there is an expectation that the value of the hedging instrument and the value of the hedged item will move in the opposite direction because of the same risk, which is the hedged risk.
37. A forward-looking prospective assessment is also required for hedging relationships designated under IAS 39. However, IFRS 9 and IAS 39 have different requirements around such prospective assessments. More specifically, paragraph 88(b) of IAS 39 states that a hedging relationship qualifies for hedge accounting only if ‘the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk.’ According to paragraph AG105 of IAS 39, a hedge is regarded as highly effective only if both of the following conditions are met:
- (a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument.
 - (b) The actual results of the hedge are within a range of 80–125 per cent.
38. These two conditions are commonly known as: i) ‘prospective test’, with reference to the fact that item (a) of paragraph AG105 requires an assessment performed on a forward-looking basis; and ii) ‘retrospective test’, given the

assessment in item (b) of paragraph AG105 is based to the actual results of the hedge. While paragraph AG105(a) of IAS 39 does not stipulate a quantitative threshold to define whether a ‘hedge is expected to be highly effective in achieving offsetting’, the staff acknowledge that practice has developed in this area and some entities might use the same range of 80-125 per cent for both assessments required in paragraph AG105 of IAS 39.

39. The effects of IBOR reform on the ‘retrospective assessment’, required by paragraph AG105(b) of IAS 39, are not considered in the staff analysis because such a retrospective assessment is based on the actual results of the hedging relationship. Disregarding the effects of IBOR reform on the actual results of a hedge could impact measurement of the hedging instrument and hedged item. This would undermine the fundamental principle in hedge accounting of offset between gains and losses on the hedging instrument and the hedged item. As noted at the December 2018 Board meeting, the staff are not considering evaluating that principle. Therefore, this paper focuses on the ‘prospective test’ required by paragraph AG105(a) of IAS 39.
40. In this paper, the requirements in paragraph 6.4.1(c)(i) of IFRS 9 (ie the existence of an economic relationship) and paragraph AG105(a) of IAS 39 (ie whether the hedge is expected to be highly effective) are collectively referred to as ‘prospective assessments’.
41. The prospective assessments provide evidence that allows an entity to make the forward-looking assertions related to the existence of an economic relationship according to IFRS 9 or expectation that the hedge will be highly effective in achieving offsetting as per IAS 39. As noted in paragraph 6, these assertions are part of the set of qualifying criteria an entity must comply with in order to apply hedge accounting. The staff highlight that these specific forward-looking assertions do not change the actual results of a hedge and thus do not affect measurement of the hedging instrument and hedged item. For example, while the prospective assessments reflect an entity’s expectation that, going forward, the hedging relationship will meet these specific criteria to qualify for hedge accounting, only the actual results of the hedge (eg changes in fair value of the hedging instrument and the hedged item in a fair value hedge) are measured and recognised in the financial statements.

42. As discussed at the December 2018 Board meeting, demonstrating the existence of an economic relationship according to IFRS 9 or expectation that the hedge will be highly effective in achieving offsetting as per IAS 39 would require the estimation of future cash flows because both assessments are prospective in nature. For those hedging relationships going beyond the expected replacement of IBOR, as time to transition approaches, the prospective assessments could be affected as they are performed on a forward-looking basis, and potentially result in discontinuation of hedge accounting.

Accounting implications

43. When an entity fails the prospective assessments, paragraph 6.5.6 of IFRS 9 and paragraphs 91(b) and 101(b) of IAS 39 require the entity to discontinue hedge accounting prospectively. The consequences of prospective discontinuation of hedge accounting are:
- (a) Regarding fair value hedges, the fair value hedge adjustment will be amortised to profit or loss. The amortisation is based on a recalculated effective interest rate at the date amortisation begins;⁴ and
 - (b) As for cash flow hedges, the accumulated amount in the cash flow hedge reserve will be reclassified to profit or loss when the hedged cash flows occur.⁵
44. In addition, while entities might re-designate the same derivatives in new hedging relationships, it is likely that these derivatives could fail the prospective assessments again due to the same reason. As a result, changes in fair value of derivatives previously designated in any cash flow hedges would start being recognised in profit or loss (instead of the cash flow hedge reserve in Other Comprehensive Income). Regarding derivatives previously designated in fair value hedges, offsetting would not be achieved in profit or loss because the hedged item would no longer be measured at fair value.

⁴ Refer to paragraph 6.5.10 of IFRS 9 and paragraphs 91-92 of IAS 39.

⁵ Refer to paragraph 6.5.12 of IFRS 9 and paragraph 101(b) of IAS 39.

Types of hedging relationships that might be affected

45. As discussed in paragraph 21, to assess the accounting implications and potential solutions, the staff considered the population of hedging relationships that might be affected by uncertainties arising from IBOR reform. Considering the prospective assessments apply to both fair value and cash flow hedges, the following hedges of interest rate risk might be affected:
- (a) *Existing IBOR hedges*: these include hedges of recognised IBOR-based instruments and forecast IBOR cash flows. For the purpose of this analysis, ‘existing’ hedges refer to hedging relationships designated before or as at the effective date of any potential amendments to IFRS 9 and IAS 39;
 - (b) *New IBOR hedges*: similar to item (a) above, these include hedges of recognised IBOR-based instruments and forecast IBOR cash flows. For the purpose of this analysis, ‘new’ hedges refer to relationships designated after the effective date of any potential amendments to IFRS 9 and IAS 39; and
 - (c) *New RFR hedges*: these refer to hedges of forecast RFR cash flows. For the purpose of this analysis, ‘new’ hedges refer to relationships designated after the effective date of any potential amendments to IFRS 9 and IAS 39.
46. Failure to meet the prospective assessments would affect existing IBOR hedges because it might be difficult for entities to demonstrate the existence of an economic relationship under IFRS 9, or the expectation that the hedge will be highly effective in achieving offsetting as per IAS 39, in a scenario where the specific conditions for IBOR reform have not been determined yet. The same applies to new IBOR hedges (ie relationships designated after the effective date of any potential amendments to IFRS 9 and IAS 39 that the Board may consider), because the uncertainties arising from IBOR reform might also affect the prospective assessments of these hedges.
47. Regarding new RFR hedges, as noted in the December 2018 Board meeting, while derivative markets could have a standardised protocol enacted, if agreed by all parties, to reduce the burden of re-negotiating outstanding contracts, the process

of amending legacy positions in the cash markets is yet to be determined. Therefore, it might be possible that in some jurisdictions the RFR derivative market develops before the RFR cash markets. In this context, assuming entities use RFR forward start swaps to hedge a forecast RFR debt issuance, as the specific conditions for IBOR reform affecting the forecast debt instrument remain uncertain (eg whether the forecast debt instrument will bear an overnight RFR or a 3-month RFR), it might be difficult for entities to demonstrate the existence of an economic relationship under IFRS 9, or expectation that the hedge will be highly effective in achieving offsetting as per IAS 39.

Staff analysis

48. The prospective assessments play an important role in ensuring the discipline around the application of hedge accounting. However, the scenario being considered, IBOR reform, is unprecedented and was not contemplated during the development of IFRS 9 and IAS 39. Therefore, for the same reasons expressed in paragraphs 24 – 29 and given the accounting consequences outlined in paragraphs 43 – 44, the staff, on balance, is of the view that the Board should consider amending IFRS 9 and IAS 39 to provide relief from the effects of IBOR reform uncertainties on the prospective assessments.
49. As discussed in paragraph 37, the words in IFRS 9 and IAS 39 are different and thus the following analysis considers the proposed relief for each standard separately.
50. Regarding IAS 39, paragraph AG105(a) states that entities can demonstrate whether the hedge is expected to be highly effective in achieving offsetting by comparing changes in fair value or cash flows of the hedged item with changes in fair value or the cash flows of the hedging instrument. Therefore, the staff think IAS 39 should be amended to provide relief from the effects of IBOR reform uncertainties on the prospective assessment. This means that, to demonstrate whether the hedge is expected to be highly effective in achieving offsetting, an entity should consider only the existing contractual terms of the hedging instrument and hedged item. Potential future amendments to underlying contracts due to IBOR reform should not affect the assertion that the hedge is expected to

be highly effective in achieving offsetting. The proposed relief is optional and applies to all types of hedges of interest rate risk noted in paragraph 45 above.

51. With respect to IFRS 9, the prospective assessment requires entities to demonstrate the existence of an economic relationship. While IFRS 9 does not specify a method for assessing whether an economic relationship exists, paragraph B6.4.13 of IFRS 9 states that an entity should use a method that captures the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness. Also, as IFRS 9 does not require a retrospective test as required by IAS 39, this increases the importance of IFRS 9 prospective assessment as a qualifying criterion. Therefore, the staff think IFRS 9 should be amended to provide relief from the effects of IBOR reform uncertainties on the positive assertion that an economic relationship exists. In particular, similar to the proposed amendments to IAS 39, the staff think IFRS 9 should be amended to clarify that a hedging relationship would not fail the prospective assessment because of uncertainties on whether and how the hedged item or the hedging instrument will be contractually amended as a result of IBOR reform. This means that, to demonstrate whether an economic relationship exists, an entity should consider only the existing contractual terms of the hedging instrument and hedged item. Regarding highly probable forecast transactions, potential future amendments to underlying contracts due to IBOR reform should not affect the assertion that an economic relationship exists. The proposed relief is optional and applies to all types of hedges of interest rate risk noted in paragraph 45 above.
52. As noted in paragraph 7, the proposals in this paper aim to provide relief only from the effects of IBOR reform uncertainties on the prospective assessments required by IFRS 9 and IAS 39. This assertion does not impact nor change the actual results of a hedge and thus does not affect measurement. Consequently, while the proposed solution would provide relief for this specific forward-looking assertion (ie the prospective assessments), entities would still need to measure and recognise ineffectiveness that may arise provided the 'lower of' test does not apply.
53. The staff are not proposing an evaluation of the fundamental concept of economic offset between the hedged item and the hedging instrument which is the pillar

supporting the hedge accounting model in both IFRS 9 and IAS 39.⁶ The staff think it is critical to maintain this fundamental concept. This means that entities would still have to evaluate whether or not such an offset exists through the prospective assessments and measurement of hedge ineffectiveness throughout the life of a hedging relationship. In other words, if a hedging relationship fails the prospective assessments due to reasons other than uncertainties from IBOR reform, the proposed relief would not apply and thus that hedging relationship should be discontinued as required by IFRS 9 and IAS 39. In addition, as discussed in paragraph 7, the staff think the economics of hedging instruments and hedged items should be captured in financial reporting and the proposals in this paper are designed to maintain this concept unchanged. In particular, the actual economics of these instruments will be captured through measurement, which is not affected by the proposed relief.

54. In case the Board agrees with the staff recommendation to amend IFRS 9 and IAS 39, we think the proposed amendments should clarify the Board's intention to provide relief from effects arising solely from IBOR reform. In other words, if a hedging relationship fails the prospective assessment due to reasons other than uncertainties on whether and how the hedging instrument or the hedged item will be contractually amended as a result of IBOR reform, that hedging relationship would not qualify for hedge accounting under IFRS 9 and IAS 39. The staff think the proposed amendments should also make it clear that all other hedge accounting requirements must be applied as stipulated by IFRS 9 and IAS 39.⁷

Illustrative example – prospective assessments

55. To illustrate the application of the proposed relief, assume the same fact pattern in paragraph 30 where an entity issues a 5-year floating-rate debt instrument, which pays interest quarterly at 3-month IBOR. The entity also enters into a 5-year interest rate swap under which it receives 3-month IBOR and pays a fixed rate of

⁶ Refer to paragraph B6.4.7 of IFRS 9.

⁷ The staff highlight that, in a similar situation in the past (June 2013), the Board considered the financial reporting effects arising from novations that result from new laws or regulations and decided to amend IAS 39 to provide relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument met certain criteria.

4.0%. Assuming the relationship meets all the qualifying criteria for cash flow hedge accounting,⁸ the entity designates the forecast 3-month IBOR interest payments as the hedged item and the interest rate swap as the hedging instrument. In this scenario, the existing contractual obligation would typically support the assertion that the forecast IBOR interest payments are highly probable at inception of the hedging relationship. As IBOR reform approaches, there would be an increased probability that the debt instrument will be amended to reflect the alternative RFR and thus, at some point, the designated forecast IBOR interest payments would fail the highly probable requirement. In this situation, the entity applies the proposed amendments discussed in paragraph 27 and thus the hedged item does not fail the highly probable requirement.

56. In addition, as part of the set of qualifying criteria an entity must comply with in order to apply hedge accounting, the entity is required to demonstrate the existence of an economic relationship under IFRS 9 (or expectation that the hedge will be highly effective, if hedge accounting is applied under IAS 39). In the illustrated scenario, uncertainties from IBOR reform might affect the entity's expectation regarding the future cash flows arising from both the hedged item (ie forecast IBOR interest payments) and the hedging instrument (ie the interest rate swap), since both instruments might be contractually amended to reflect the alternative RFR. While the general conditions (timing and specifics) for the replacement of IBOR have not been determined yet, applying the proposed relief to the prospective assessments would allow the entity to consider only the existing contractual terms of the hedging instrument and hedged item until they are amended to reflect the alternative RFR.
57. It is important to note the proposed amendments would provide relief from the effects of IBOR reform uncertainties on specific forward-looking assertions an entity needs to make when applying hedge accounting. As noted in paragraph 7, these assertions do not change the actual results of the hedge and thus do not affect measurement of the hedging instrument and hedged item. For example, continuing the above scenario, as conditions of IBOR reform develop and time to

⁸ While this relationship qualifies for cash flow hedge, as noted in paragraph 36 of this paper, the staff highlight that the prospective assessments applies to both fair value and cash flow hedges.

transition approaches, assume liquidity constraints start affecting the fair value of designated hedging instrument (ie the interest rate swap). This would represent the economics of the hedging instrument and therefore would be captured in financial reporting through measurement of the interest rate swap. In other words, the interest rate swap would continue to be measured at fair value on the statement of financial position with the effective portion of changes in fair value recorded in the cash flow hedge reserve and any remaining gain or loss recognised in profit or loss, provided the 'lower of test' does not apply.

58. The staff highlight that, if the hedging relationship failed the highly probable requirement or the prospective assessments due to any reason other than uncertainties on whether and how the hedging instrument or the hedged item will be contractually amended as a result of IBOR reform, that relationship would not qualify for hedge accounting. This is because the proposed amendments provide relief from effects arising solely from IBOR reform uncertainties.
59. The period over which entities could apply such a relief is discussed in paragraphs 95 – 104.

Staff recommendation

60. For the reasons stated in paragraphs 48 – 59, the staff are of the view that IAS 39 and IFRS 9 should be amended to provide relief from the effects of IBOR reform uncertainties on the prospective assessments. This means that, to demonstrate the existence of an economic relationship in accordance with IFRS 9, or whether the hedge is expected to be highly effective in achieving offsetting as per IAS 39, an entity should consider the existing contractual terms of the hedging instrument and hedged item until they are amended to reflect the alternative RFR. Regarding highly probable forecast transactions, potential future amendments to underlying contracts due to IBOR reform should not affect the assertions that an economic relationship exists in accordance with IFRS 9 or the hedge is expected to be highly effective in achieving offsetting as per IAS 39.
61. Providing such a relief would not impact measurement of the hedged item nor the hedging instrument because the prospective assessments do not change the actual results of a hedge. Entities would still have to perform the prospective assessments and measure hedge ineffectiveness throughout the life of a hedging

relationship. Relief is provided solely from uncertainties arising from IBOR reform.

Question for the Board

Question for the Board

- 1) Does the Board agree with the staff recommendation in paragraphs 33 - 35 and 60 that IFRS 9 and IAS 39 should be amended to provide relief from the effects of IBOR reform uncertainties on the highly probable requirement and prospective assessments required in both standards?

Risk components

62. Following the December 2018 Board meeting, the staff received additional feedback from constituents and considered whether the requirements for designation of a risk component as the hedged item in a hedging relationship could be impacted by IBOR reform. These issues could affect financial reporting before IBOR reform is enacted, as they could lead to discontinuation of hedge accounting and/or preclude designation of new hedging relationships, and thus are addressed in the first phase of the project.

Background

63. An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. More specifically, paragraph 6.3.7(a) of IFRS 9 and paragraph 81 of IAS 39 allow entities to designate only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component). For example, assuming an entity issues a 5-year floating-rate debt instrument that bears interest of 3-month LIBOR + 1%, the entity could designate either the entire debt instrument (ie all of the cash flows) or the 3-month LIBOR risk component of the floating-rate debt instrument.
64. While the words in IFRS 9 and IAS 39 are slightly different, both standards require a risk component to be separately identifiable and reliably measurable (SIRM). In addition, although the permitted risk components of non-financial

assets are different in IFRS 9 and IAS 39, designation of non-financial items is not relevant for this paper. This is because, as noted in paragraph 11, this paper focuses on hedges of interest rate risk only.

65. The SIRM requirement applies to both cash flow and fair value hedges. In particular, paragraph B6.3.8 of IFRS 9 states:

To be eligible for designation as a hedged item, a risk component must be a separately identifiable component of the financial or the non-financial item and the changes in the cash flows or the fair value of the item attributable to changes in that risk component must be reliably measurable.

66. Similarly, paragraph AG99F of IAS 39 states:

To be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the cash flows or fair value of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable.

67. When designating risk components as hedged items, an entity considers whether the risk component is explicitly specified in a contract (contractually specified risk components) or whether they are implicit in the fair value or the cash flows of an item of which they are a part (non-contractually specified risk components). The assessment of whether a risk component is separately identifiable may be straight forward when the component is explicitly stated in a contract. In the example above, 3-month LIBOR is a separately identifiable risk component because the risk component is explicit in the contract. The staff expect limited impacts of IBOR reform on the assessment of whether contractually specified risk components are separately identifiable for both IFRS 9 and IAS 39 because contractually specified components are a matter of fact and thus would require limited judgement.
68. Identifying a non-contractually specified risk component is more difficult. It requires an assessment of facts and circumstances around the particular market structure to which the risks relate. To determine whether a risk component is

SIRM, an entity assess such risk components within the context of the particular market structure to which the risk relates and in which the hedging activity takes place.⁹ In that respect, paragraph B6.3.10(d) of IFRS 9 provides the following example where a benchmark rate such as LIBOR is separately identified as a non-contractually specified risk component of the debt instrument:¹⁰

Entity D holds a fixed-rate debt instrument. This instrument is issued in an environment with a market in which a large variety of similar debt instruments are compared by their spreads to a benchmark rate (for example, LIBOR) and variable-rate instruments in that environment are typically indexed to that benchmark rate. Interest rate swaps are frequently used to manage interest rate risk on the basis of that benchmark rate, irrespective of the spread of debt instruments to that benchmark rate. The price of fixed-rate debt instruments varies directly in response to changes in the benchmark rate as they happen. Entity D concludes that the benchmark rate is a component that can be separately identified and reliably measured. Consequently, Entity D may designate hedging relationships for the fixed-rate debt instrument on a risk component basis for the benchmark interest rate risk.

69. In this example, LIBOR can be identified as a risk component because variable-rate instruments in that environment are typically indexed to LIBOR and interest rate swaps are frequently used to manage LIBOR risk.
70. The above example illustrates a fact pattern where a non-contractually specified risk component is considered SIRM, however, paragraph B6.3.14 of IFRS 9 discusses an example of market structure in which a non-contractually specified risk component cannot. In particular, paragraph B6.3.14 of IFRS 9 states:

[...] in many cases an inflation risk component is not separately identifiable and reliably measurable. For example, an entity issues only nominal interest rate debt in

⁹ Refer to paragraph B6.3.9 of IFRS 9.

¹⁰ A similar example is provided in paragraph AG99F of IAS 39.

an environment with a market for inflation-linked bonds that is not sufficiently liquid to allow a term structure of zero-coupon real interest rates to be constructed. In this case the analysis of the market structure and of the facts and circumstances does not support the entity concluding that inflation is a relevant factor that is separately considered by the debt markets. Hence, the entity cannot overcome the rebuttable presumption that inflation risk that is not contractually specified is not separately identifiable and reliably measurable [...]. This applies irrespective of any inflation hedging instrument that the entity has actually entered into.

71. The above example illustrates a market structure that is not sufficiently liquid to allow a term structure of zero-coupon real interest rates to be constructed and concludes that hedge accounting is not achieved because the risk component is not separately identifiable.
72. The most specific guidance in IAS 39 is found in its paragraph 81 which states ‘an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument)’. While the words in IFRS 9 and IAS 39 are not the same, the staff believe this does not impact the analysis in this paper because the concepts and principles are very similar.

Implications

73. In order to qualify for hedge accounting, the hedged item must be eligible and more specifically, if a risk component is the designated hedged item, it must be separately identifiable. In view of this, assuming a scenario where IBOR reform impacts market liquidity to an extent that there is no available term structure of zero-coupon interest rate for either IBOR or RFR benchmarks, this could affect the assessment of whether non-contractually specified IBOR and RFR components are eligible as a hedged item in a hedging relationship.
74. With respect to new IBOR and new RFR hedges, if the situation described in paragraph 73 occurs, new designations of IBOR and RFR as non-contractually

specified risk components would be prevented because they would not be separately identifiable at initial designation irrespective of any hedging instrument that the entity has actually entered into. Alternatively, entities could designate the entire fair value or all the cash flows of the interest-bearing financial instrument in a hedging relationship. However, the entity would be required to measure the effectiveness of that relationship based on all the cash flows (or fair value), rather than a component. This would most likely increase measured ineffectiveness. This implies, at a minimum, achieving hedge accounting would be more difficult for IBOR-based hedging instruments when a term structure of zero-coupon IBOR interest rates cannot be constructed. These concerns apply equally to RFR based hedging instruments if a term structure of zero-coupon RFR interest rates cannot be constructed.

75. While paragraph 74 discusses the concerns raised on new designations, another question remains regarding the impact, if any, on hedging relationships designated prior to the inability to demonstrate separately identifiability. This is discussed in the following paragraphs.

Frequency of SIRM assessment and implications for existing IBOR hedges

76. The discussion about frequency of the SIRM assessment is important because this will define the population of hedging relationships affected by IBOR reform with respect to the separately identifiable requirement.
77. IAS 39 and IFRS 9 provide specific guidance about requirements that must be met only at initial recognition (eg embedded derivatives, SPPI test, etc). Both standards also provide explicit guidance when other assessments need to be performed on a continuous basis (ie prospective assessments, the highly probable requirement, etc). Risk components that are separately identifiable are generally discussed in the context of initial designation, which occurs at inception of the hedging relationship.
78. In particular, while paragraph 81 of IAS 39 states that an identifiable and separately measurable portion of the interest rate exposure is eligible for hedge accounting purposes, there is no explicit requirement for a continuous assessment. The same applies to IFRS 9, since paragraph 6.3.7 states that an entity may designate a risk component provided it is separately identifiable and reliably

measurable. In addition, the SIRM requirement is discussed in section ‘Designation of hedged items’ of IFRS 9 and, because designation of hedge accounting occurs only at inception of a hedging relationship, it can be argued that identification is only required at the time of designation.

79. The staff also note that, once the risk component has been separately identified, this will define the basis for assessing ineffectiveness of that relationship going forward. For example, for cash flow hedges, the designated risk component would define the characteristics of the hypothetical derivative. In case of fair value hedges, the risk component will define the basis for measuring the fair value adjustment on the hedged item. Since neither the hypothetical derivative nor the basis on which the fair value adjustment is measured change over the life of a hedging relationship, there is no need to separately re-identifying a risk component that has already been defined and designated at the inception of hedging relationship.
80. For the reasons discussed in paragraphs 76 - 79, the staff think the assertion of separate identifiability is required only at initial designation of a hedging relationship. Therefore, in the event that entities can no longer assert IBOR is separately identifiable based on market structure, this would not require the discontinuation of relationships already designated.

New designation: Relevant scenarios

81. As discussed in paragraph 80, given that the requirement for separate identification applies only at inception of the hedging relationship, non-contractually specified IBOR components designated in existing hedging relationships would not be impacted by IBOR reform nor would new designations as long as IBOR continue to be separately identifiable. This significantly reduces the scope of the potential concerns involving new relationships where the entity wants to designate a non-contractually specified risk component. Realistically, the concerns discussed in this paper will arise in two scenarios:
- (a) When an entity wishes to designate the alternative RFR as a risk component when a term structure of zero rates is available for IBOR but the RFR market has not yet sufficiently developed; or

- (b) When an entity wishes to designate IBOR as a risk component but the market has transitioned away from IBOR to the alternative RFR and a term structure of zero rates is no longer available for IBOR.
82. A scenario where neither IBOR or RFR is separately identifiable was not considered in our analysis because it is unlikely that there would be no available term structure of zero-coupon interest rate for both IBOR and RFR benchmarks in the same period. This would imply a greater impact in interest rate markets which seems unlikely at this stage.
83. In addition, if IBOR is no longer separately identifiable but the RFR is, this would indicate reform has been enacted and thus any issues arising on transition would be addressed in the second phase of the project as more information about IBOR reform becomes available.
84. Therefore, the scope of the concern surrounding designation of new relationships appears limited to RFR based hedging activities when the RFR market has not yet developed to a stage where a term structure of zero-rates can be constructed.

Staff analysis

85. Amending IFRS 9 and IAS 39 to provide relief from this requirement would permit entities to designate IBOR and RFR as non-contractually specified risk components even though the component may not be separately identifiable at the time of designation. In other words, IBOR and RFR would be considered separately identifiable regardless of the market structure for a period of time. In the following paragraphs, the staff discuss two possible views:
- (a) View A: not to amend IFRS 9 and IAS 39
- (b) View B: amend IFRS 9 and IAS 39

View A: not to amend IFRS 9 and IAS 39

86. The staff is concerned that any proposed solution for risk components would impact the definition of the hedged item. Without a term structure of zero-coupon interest rates, the entities' ability to independently define the hedged item would be reduced. For example, due to the lack of observable data, entities would likely estimate changes in fair value of the hedged item based on the same valuation inputs used to estimate changes in fair value of the hedging instrument. The staff

is concerned that this would violate the view that the ‘hedge accounting model requires that the value of the hedged item is measured independently of that value of the hedging instrument’ and, consequently, the general notion of offset between gains and losses on the hedging instrument and the hedged item on which the hedge accounting model in IFRS 9 and IAS 39 is based.¹¹ Additionally, this would contradict the statement that “the entity cannot simply impute the terms and conditions of the actual inflation hedging instrument by projecting its terms and conditions onto the nominal interest rate debt” made in paragraph B6.3.14 of IFRS 9.

87. The staff also think that allowing designation of non-contractually specified RFR components when such components are not separately identifiable could be challenging. This is because the future of these RFR benchmarks is unknown and thus unintended consequences could arise as a result of such relief. For example, according to paragraph 6.5.8(b) of IFRS 9 and paragraph 89(b) of IAS 39, in a fair value hedge, the gain or loss on the hedged item should adjust the carrying amount of the hedged item and be recognised in profit or loss. Therefore, if a risk component that is not separately identifiable is designated in a fair value hedge, this would result in recognition of gains or losses in the statement of profit or loss for a component that is not separately identifiable.
88. Furthermore, if designation of risk components that are not separately identifiable was permitted, this would indicate that the designated component is separately considered by the market when determining the fair value of the hedged item. This may distort the underlying economics of the hedge relationship because it implies measurement of effectiveness is based on the structure of the relevant market, even though that may not be the case. One could argue the resulting information may not be useful for users of financial reporting.
89. It is important to note that if relief is provided for non-contractually specified RFR components, the staff anticipate that it could be challenging to identify and define each RFR for which relief would be provided. This is because, although there is some detail on what the new RFR can be in certain jurisdictions, the replacement will occur in several jurisdictions, and IFRS Standards do not provide

¹¹ Refer to paragraph B6.4.7 of IFRS 9 and paragraph BC6.290 of the Basis for Conclusions of IFRS 9.

a prescriptive list of rates eligible as risk components. In addition, even if more information becomes available and it is possible to identify and define a comprehensive list of RFR benchmarks eligible as risk components, it might not be possible for the staff to predict whether all RFR will become separately identifiable in the future. Said differently, the staff cannot guarantee that all alternative RFRs will eventually meet the separately identifiable requirement and therefore, a relief that was once expected to be provisional, could become indeterminately applicable.

90. Finally, the staff highlight that entities would be able to designate a financial instrument in its entirety (ie all cash flows or full fair value) as an alternative to component hedging. While this would result in more ineffectiveness, all other things being equal, hedge accounting would still be permitted.

View B: amend IFRS 9 and IAS 39

91. Amending IFRS 9 and IAS 39 to provide relief from this requirement would permit entities to designate IBOR and RFR as non-contractually specified risk components when that component is not separately identifiable. In other words, IBOR and RFR would be considered separately identifiable regardless of the market structure for a period of time. The period over which entities could apply such a relief is discussed in paragraphs 95 – 104.
92. The staff think this would provide a clear direction to constituents regarding the eligibility of these benchmarks as a risk component and thus would reduce uncertainties regarding future designations due to the effects of IBOR reform. As noted in paragraph 25, the inability to qualify for hedge accounting could have an impact on financial reporting and key accounting ratios (including regulatory ratios such as CET 1) for a number of IFRS preparers globally. Given the unique nature of IBOR reform and the expectation of a smooth transition from IBOR to the alternative RFR, one could argue that requiring fair value through profit or loss for certain hedging instruments would not provide useful information to users of financial reporting.
93. Specifically, regarding new RFR hedges, given the market expectation is that the alternative RFR will replace IBOR, one could argue that this relief is temporary in nature and therefore, the concerns raised in paragraph 86 – 90 are lessened.

Staff recommendation

94. On balance, considering the arguments stated in paragraphs 86 – 93, the staff are of the view that the Board should not amend the hedge accounting model in IFRS 9 and IAS 39 to provide relief for designation of risk components that are not separately identifiable. The staff do not think the impacts on definition of the hedged item and consequential impacts on ineffectiveness are warranted given the affected population of hedging relationships, especially considering the clarification already provided in paragraph 80 regarding frequency of assessment.

Question for the Board

Question for the Board

- 2) Does the Board agree with the staff recommendation in paragraph 94?

End of the proposed relief

95. We use the term ‘IBOR reform’ to refer to a market wide reform of benchmark interest rates. The staff note that IBOR reform will likely follow different timelines in different jurisdictions. In this context, the staff highlight that it is difficult to define a period of applicability for the proposed amendments because, thus far, there are no dates specifying when IBOR reform will start and when it will end.
96. While, at this stage, it is not possible to determine the end of IBOR reform, the staff think it is important to define when the relief proposed in this paper will no longer be available. This is because the transitional period from IBOR to new RFR will be temporary and, without defining the end of the proposed relief, the Board will need to amend IFRS 9 and IAS 39 again when uncertainties arising from IBOR reform are no longer present and thus there would be no need for such relief. However, given that markets may develop at different speeds, proposing an approach whereby the proposed relief is deleted at some point in the future is difficult because it would preclude certain jurisdictions from using the relief when it may be required whilst allowing it for others where it is not. Therefore, the staff

think the end of the proposed relief needs to be linked to the structure of the market.

97. In view of this, if the Board agrees with the recommendations in this paper, the following paragraphs discuss the period over which an entity could apply the proposed relief.

Highly probable requirement and prospective assessments

98. The proposed amendments provide relief from uncertainties arising from IBOR reform that would otherwise impact the highly probable requirement and prospective assessments in IFRS 9 and IAS 39. As a result, when these uncertainties are no longer present, entities would not require relief from the requirements of IFRS Standards as originally issued. In this context, the staff have identified two questions regarding hedge relationships:

- (a) When should hedging relationships that have used the proposed relief stop using the said relief; and
- (b) When should designation of new relationships revert to the hedge accounting requirements as originally written (ie they need to be designated without using the proposed relief).

99. For the first group of transactions (ie hedging relationships using the proposed relief), when an IBOR financial instrument is contractually amended to reflect the alternative RFR, the uncertainties arising from IBOR reform would no longer affect both the highly probable requirement and the prospective assessments. Therefore, the staff think an entity should stop applying the proposed relief when the earlier of the following occurs:

- (a) the designated IBOR financial instrument is contractually amended to replace IBOR for the alternative RFR; or
- (b) the hedging relationship terminates.

100. In addition, as noted in paragraph 19, IBOR reform might also impact reclassification of the amount accumulated in the cash flow hedge reserve related to hedging relationships that have been previously discontinued for reasons other than IBOR reform. For the same reasons stated in paragraph 99 above, an entity should apply the proposed relief for this specific scenario until the earlier of

contractual amendment or the cash flow hedge reserve has been fully reclassified to the statement of profit or loss. This would allow these relationships to “run-off” until they are contractual amended. The impact of contractual amendments on existing hedge relationships will be discussed in Phase II of the project.

101. The staff think that when the alternative RFR becomes separately identifiable, this implies the market has developed and entities should have clarity regarding the transition from IBOR to the alternative RFR and the impact on their contracts and operations. Consequently, with respect to the second group of hedging relationships noted in paragraph 99(b) above, the staff propose that entities be not permitted to apply the proposed relief for all hedging relationships designated after the RFR is separately identifiable. This is because, when the RFR is separately identifiable, there would be no uncertainty arising from IBOR reform and thus no need for such relief. At this point, entities must use the requirements of IFRS Standards as originally issued.

Risk components

102. As noted in paragraph 94, the staff is not recommending relief for designation of risk components that are not separately identifiable. However, in case the Board decides to provide relief for such risk components, the staff have considered the period over which an entity should apply such relief.
103. For those relationships that have applied relief, given that separate identification is required at initial designation only, the staff think entities should stop applying the proposed relief when the earlier of the following occurs:
- (a) the designated IBOR financial instrument is contractually amended to replace IBOR for the alternative RFR; or
 - (b) the hedging relationship terminates.
104. Similarly, with respect to the second group of hedging relationships noted in paragraph 98(b) above, the staff propose that entities be prohibited from applying the proposed relief for all hedging relationships designated after the RFR is separately identifiable. This is because, when the RFR is separately identifiable, the relief becomes redundant as entities would be able to meet the separately identifiable requirement when designating the RFR as a risk component.

Question for the Board**Question for the Board**

3) Does the Board agree with the staff recommendation regarding end of relief?

Disclosures

105. As noted in paragraph 7, the proposals discussed in this paper aim to provide relief from the effects of IBOR reform uncertainties on the highly probable requirement and prospective assessments required by IFRS 9 and IAS 39. Therefore, the objective of the disclosures discussed in the proceeding paragraphs is to provide users with information about the extent to which entities are applying the proposed relief.
106. The staff note that *IFRS 7 – Financial Instruments: Disclosures* (IFRS 7) already requires specific disclosures about hedge accounting. The staff think that some of these IFRS 7 disclosures, if provided in the context of entities applying the proposed relief, would achieve the objective noted in paragraph 105 above. The staff think the proposed disclosures will not be onerous to preparers because these disclosures are already required by IFRS 7 for existing hedges.
107. The staff propose that an entity applying the proposed relief should disclose the following information in the notes of the financial statements:
- (a) For hedging instruments in either fair value or cash flow hedges:¹²
 - (i) the carrying amount;
 - (ii) the nominal amount; and
 - (iii) the change in fair value used as the basis for recognising ineffectiveness for the period.
 - (b) For hedged items in fair value hedges:¹³
 - (i) the carrying amount;

¹² Consistent with paragraph 24A of IFRS 7.

¹³ Consistent with paragraph 24B(a) of IFRS 7.

- (ii) the accumulated amount of fair value hedge adjustments;
 - (iii) the line item in the statement of financial position that includes the hedged item; and
 - (iv) the change in fair value used as the basis for recognising ineffectiveness for the period.
- (c) For cash flow hedges:¹⁴
- (i) the balance in the cash flow hedge reserve and the amount transferred to profit or loss; and
 - (ii) the change in fair value used as the basis for recognising ineffectiveness for the period.

108. In practice, the staff expect that entities applying the proposed relief will provide these disclosures as a subset of the information already required by IFRS 7 in the context of hedge accounting.

Questions for the Board

Questions for the Board

4) Does the Board agree with the staff recommendation regarding disclosures?

Effective date

109. If the Board agrees with the recommendations in this paper, the staff think the relief should be made available as soon as possible to allow entities to apply the relief before it is required to discontinue hedge accounting due to the uncertainties arising from the IBOR reform. The staff therefore recommend the proposed effective date of annual periods beginning on or after 1 January 2020. In addition, the staff think that earlier application should be permitted for the same reason.
110. With respect to the application, the staff think the relief should be applied retrospectively. The staff highlight that retrospective application is limited to the application of the specific relief proposed in the amendments. This means that it

¹⁴ Consistent with paragraph 24B(b) of IFRS 7.

would not allow reinstating hedge accounting that has already been discontinued in previous financial statements. Nor would it allow designation in hindsight. If an entity had not designated an item as a hedging instrument or a hedged item in a qualifying hedging relationship, this relief, even if applied retrospectively, would not allow the entity to go back in time to designate such an item as a hedge that qualifies for hedge accounting. Doing so would be against the requirement that hedge accounting applies prospectively. Retrospective application of the relief would enable entities to continue hedge accounting for a hedging relationship that the entity has already designated and that qualifies for hedge accounting applying IAS 39 or IFRS 9.

111. The staff note that this approach is consistent with the approach taken for the *Novation of Derivatives and Continuation of Hedge Accounting* (Amendments to IAS 39 and IFRS 9).
112. With respect to transition provision, the staff do not think any specific transition provisions are necessary given the proposed relief is intended to help entities continue applying the same accounting as the entity is already applying as opposed to transiting to new requirements. The staff therefore do not propose any specific transition provisions.

Question for the Board

Question for the Board

- 5) Does the Board agree with the staff recommendation regarding the effective date?

High-level project timeline

113. If the Board decides to proceed with the proposed amendment described in this paper, we think that proposal should be published as quickly as possible.

114. We have prepared a high-level project timeline assuming a short comment period. We have prepared an agenda paper to inform the Due Process Oversight Committee (DPOC) about the urgency of the project. Subsequent to the discussions with the Board, the staff plan to request the DPOC for approval of a short comment period.

| Timeline | Project plan |
|--------------------------|--|
| March 2019 | Board finishes deliberations, including the comment period, due process steps and permission to ballot. Proceed with drafting those amendments. |
| April / May 2019 | Publish an Exposure Draft |
| June / July 2019 | Comment period ends |
| September / October 2019 | Board re-deliberations |
| November / December 2019 | Issue final amendment |