

STAFF PAPER

July 2019

IASB® meeting

Project	IBOR Reform and its Effects on Financial Reporting		
Paper topic	Additional issues for consideration before finalising the proposed amendments		
CONTACT(S)	Fernando Chiqueto	fchiqueto@ifrs.org	+44 (0) 20 7246 6496
	Riana Wiesner	rwiesner@ifrs.org	+44 (0) 20 7246 6412

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in the IASB® *Update*.

Introduction

1. At the time of discussing the proposed exceptions to be included in the Exposure Draft (ED) *Interest Rate Benchmark Reform* (proposed amendments to IFRS 9 and IAS 39), the Board noted that a range of issues, that might affect financial reporting when existing interest rate benchmarks such as interbank offer rates (IBORs) are replaced with alternative interest rates (RFRs), could arise at different points in time due to the uneven timing of the replacement coupled with different approaches to replacement being considered in different markets. The Board therefore decided to monitor developments in this area and as more information becomes available, assess the potential financial reporting implications and determine whether it should take any action and, if so, what.
2. As noted in *Agenda Paper 14A: Summary of feedback from comment letters*, most respondents to the ED provided comments not only on the specific questions asked, but also on potential issues and approaches for the Board to consider, either as part of the finalisation of the proposed amendments or as part of the next phase of the IBOR project. There was also general consensus among respondents that the proposals in the ED should be finalised and published as soon as possible and that any issue that could potentially result in the re-exposure of the proposals in the ED should be dealt with as part of the next phase of the project.

3. During the staff’s research and outreach since the February 2019 Board meeting, a number of matters were identified that could have a significant impact on financial reporting as a result of the reform and of which the matters discussed in this paper is a subset of.

Purpose of this paper

4. The purpose of this paper is to provide the Board with a summary on each of the matters discussed and includes a short description of the current accounting requirements, the feedback received and, where relevant, the potential approaches suggested by respondents on how to resolve the concerns raised. However, this does not include any of the potential drafting improvements or clarifications to the proposals in the ED as these are discussed in Agenda Paper 14A.
5. This paper does not include any staff analysis or recommendations to the Board therefore, the staff is also not asking the Board to make any decisions based on this paper. The purpose is purely to provide the Board with some background on each matter. However, to assist with the staff with their analysis of the various matters and any potential ways in which the matters could be addressed, it will be helpful to know if the Board has any views or observations on any of these matters or potential solutions suggested by the respondents. We have therefore included a question at the end of this paper to this effect.

Summary of issues for the Board to consider

6. In addition to the potential clarifications and amendments identified in Agenda Paper 14A, the following additional issues for consideration have been identified:
- (a) IAS 39 retrospective assessment (paragraphs 7–14);
 - (b) Modification vs. derecognition of financial assets and liabilities (paragraphs 15–21); and
 - (c) Changes to hedge documentation (paragraphs 22–31).

IAS 39 retrospective assessment*Accounting requirements*

7. 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.

8. In considering the usefulness of information that would result from the potential discontinuation of affected hedge accounting relationships, the Board decided to provide an exception to the prospective assessment required by paragraph AG105(a) of IAS 39.

9. It was noted in paragraph BC23 of the ED, that the Board decided not to propose any exception for the effects of interest rate benchmark reform on retrospective assessments as these are based on the actual results of the hedging relationship. This is because the changes in the fair values of the hedged item and the hedging instrument are determined based on the actual results of the hedge accounting relationship and existing IFRS Standards already provide an adequate basis for such measurement. In addition, as noted in paragraph BC22 of the ED, the proposals are not intended to change the measurement of hedge effectiveness or to change how hedges are reflected in the financial statements.

Feedback received on ED

10. As noted in Agenda Paper 14A for this meeting, although the ED did not include a specific question on the retrospective assessment, most of the respondents to the ED specifically commented on the Board's view expressed in BC23 and *agreed* with the statement that the actual results of a hedge should continue to be *measured and recognised* in accordance with IFRS Standards. Respondents noted that ineffectiveness arising in hedge accounting relationships should continue to be recognised in the financial statements, irrespective of whether ineffectiveness arises from interest rate benchmark reform or for any other reasons.
11. However, most respondents *disagreed* with the Board's view not to provide an exception for the effects of interest rate benchmark reform on retrospective *assessments* that would prevent entities from discontinuing hedge accounting because they are temporarily outside the 80–125% range solely due to the effects of the reform. They consider that, for the exceptions proposed in the ED to achieve their objective of not disrupting hedge accounting due to the uncertainty of interest rate benchmark reform, the uncertainty should also be excluded for the purposes of the retrospective assessment similar to the exception provided for prospective assessments.
12. These respondents highlighted that the primary reason to necessitate the relief from the retrospective assessment is the inherent interaction between the assessment of the forward-looking cash flows of the hedged item and its impact on both retrospective and prospective assessments. They noted that is common practice for entities to use the same method of effectiveness assessment (whether it is regression analysis or “dollar-offset”) for both prospective and retrospective assessments. Therefore, according to the respondents there would be an inconsistency if, for the purpose of the prospective assessment the uncertainty of the reform is not reflected, but for the purpose of the retrospective assessment the uncertainty should be reflected.
13. Some of the other reasons respondents noted to support the request for relief from the retrospective assessment, can be summarised as follows:
 - a) Discontinuation of hedge accounting resulting from breaching the 80-125% range solely due to temporary ineffectiveness caused by the reform, would

not reflect an entity's risk management strategy and would not provide useful information to the users of the financial statements. Temporary ineffectiveness could for example arise when the hedged item and hedging instrument transition to an alternative benchmark rate at different times.

- b) IFRS 9 does not require a specific retrospective assessment and therefore entities that are applying the IFRS 9 hedge accounting requirements would have an advantage over those applying IAS 39. This is because of the increased risk of breaching the 80-125% range solely due to the effects of the reform that could cause the IAS 39 hedges to be discontinued whereas the same hedges under IFRS 9 will continue as long as there is an economic relationship between the hedged item and hedging instrument.
- c) The reform is a market-wide change to the market structure of interest rates and discontinuing hedge accounting during the transition period when hedge accounting relationships would otherwise be good, would not provide useful information to the users of financial statements or reflect the economic relationship between the hedged item and the hedging instruments.

Potential approaches identified

14. Respondents made several suggestions for how the Board could address their concerns. Some of the suggestions are more limited in their application whereas others could potentially provide relief beyond the effects of the interest rate reform. However, respondents were unanimous in their view that the ineffectiveness should be measured and recognised in accordance with the current requirements in IFRS 9 and IAS 39. The approaches suggested by respondents to provide relief from discontinuing hedge accounting in accordance with IAS 39 solely because of uncertainties caused by the reform, can be summarised as follows:

- (a) *Apply the same relief as for prospective assessment:* for the purpose of retrospective assessment exclude the uncertainty from benchmark interest rate reform and assume that the interest rate benchmark on which the hedged cash flows are based, are not changed.
- (b) *Require the existence of an economic relationship:* for hedge accounting relationships affected by the reform, entities should be required to demonstrate the existence of an economic relationship

between the hedged item and the hedging instrument, similar to the requirements in IFRS 9 (as amended in the Exposure Draft¹). This would provide a consistent approach with regards to the benchmark interest rate reform under both Standards between entities with similar hedge accounting relationships.

(c) *Provide exemption from the IAS 39 ineffectiveness threshold:*

respondents identified two variations on this approach, being -

- i. *Provide relief if incremental ineffectiveness is caused by reform:* suggestions were made for both qualitative and quantitative assessments to assess the incremental ineffectiveness arising from the reform. A qualitative assessment would require entities to qualitatively identify the sources of ineffectiveness and any incremental ineffectiveness caused by the reform will be exempt from the IAS 39 threshold. On the other hand, a quantitative assessment would require the effectiveness calculations to be performed both with and without the effects of the reform in order to accurately identify the reason for breaching the threshold. However, these respondents also acknowledged that doing this assessment, in particular distinguishing only the incremental ineffectiveness caused by reform may be complex and burdensome.
- ii. *Require prospective assessment only:* IAS 39 retrospective assessment would be temporarily suspended until transition is complete. During this period entities would need to comply with the prospective assessment only.

¹ In other words, when an entity demonstrates the existence of an economic relationship, the entity would assume that the benchmark on which the hedged cash flows are based, and/or the benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of the reform.

Modification vs. derecognition of financial instruments

Accounting requirements

15. IFRS 9 includes requirements for determining how to account for a renegotiation or modification of contractual cash flows for both financial assets and liabilities. Paragraph 3.3.2 of IFRS 9 states that an exchange between an existing borrower and lender of a debt instrument with substantially different terms shall be accounted for as an extinguishment of the original liability and the recognition of a new liability.² Paragraph B5.4.6 of IFRS 9 then provides requirements for calculating the gain or loss arising from the modification that did not result in derecognition of the financial liability. Similar requirements to account for a modification gain or loss on financial assets are provided in paragraph 5.4.3 of IFRS 9.

Feedback received on the ED

16. Many respondents specifically commented on the amendments to the contractual terms of financial instruments and the uncertainty about whether such amendments could result in the derecognition of financial instruments solely due to the replacement of one benchmark interest rate with alternative interest rate as part of the wider reform. Some of these respondents acknowledged that amendments to contractual terms of financial instruments might lead to different accounting consequences depending on the specific facts and circumstances of each amendment.
17. The potential accounting implications were illustrated in the comment letters by using different scenarios where the terms of a financial instrument are amended in the context of the reform. Some of these scenarios included:
- (a) *Changes in contractual terms directly related to the reform:*
Respondents asked whether a modification that is limited to facilitating the replacement of the benchmark rate with alternative interest rate and

² The Interpretations Committee noted in its September 2012 agenda decision *IAS 39 Financial Instruments; Recognition and Measurement-Derecognition of financial instruments upon modification* that paragraph 3.3.1 (previously paragraph 17(a) of IAS 39) can by analogy be applied to financial assets.

is therefore not intended to transfer value, could be considered a not substantial modification.

- (b) *Insertion of fallback provisions:* Consideration of whether the insertion of a permanent fallback /transition provision in the terms of an existing contract triggers the immediate recognition of a modification gain or loss under paragraph 5.4.3 of IFRS 9 or results in a substantially different instrument.
- (c) *Changes in the calculation methodology of an interest rate benchmark:* changes to certain benchmark interest rates may not require explicit contractual changes although the economics of the contract and therefore the contractual cash flows will change. For example, the EONIA calculation methodology will change from its current approach to €STR plus a fixed spread but will still be called EONIA. Another example mentioned was Euribor where the index will continue although a new “hybrid” methodology is applied for the calculation. Respondents were of the view that this is only a change in methodology and should not lead to the modification or derecognition of the existing instrument.
- (d) *Changes in contractual terms not directly related to the reform:* Respondents also noted that it is likely that the transition of many instruments from IBORs to RFRs will require bilateral negotiation which may result in changes to other features such as collateral arrangements, the credit spread and adjustments for changing market liquidity.

18. There are also some ‘knock-on’ consequences from concluding that an amendment to the contractual terms should be accounted for as either a modification or a derecognition event. For example, some respondents noted that the derecognition of financial instruments in these circumstances could have significant and unintended consequences for the recognition and measurement of expected credit losses. For example, the derecognition of an IBOR financial asset and recognition of a new RFR financial asset could change the allowance for expected credit losses in accordance with IFRS 9 from a lifetime expected credit loss (if the instrument previously experienced a significant increase in credit risk

since initial recognition) to a 12-month expected credit loss as it will revert to Stage 1 following derecognition despite there being no change in the credit risk of the underlying asset.

19. Similarly, a few respondents also commented that the derecognition of financial assets and liabilities that are designated in effective hedge accounting relationships could result in those hedges being discontinued, which will override the relief proposed in the ED.
20. In view of the potentially large number of contracts which might be affected by the reform, respondents requested the Board to consider the interaction of the reform and the accounting requirements for modification and derecognition of financial instruments by providing guidance on how to apply the requirements in IFRS 9. In addition to the matters discussed above, respondents also requested clarification of:
 - (a) The application of the '10 per cent' test to financial assets; and
 - (b) The interaction between the recognition of a modification gain or loss and prospective changes in the effective interest rate in accordance with paragraphs 5.4.3 and B5.4.6 of IFRS 9 respectively.

Potential approaches identified

21. Respondents identified various potential approaches —the main themes from such approaches included:
 - a) Providing application guidance and clarity on how to apply the requirements in IFRS 9 in order to distinguish between changes to contractual cash flows that give rise to a modification gain or loss and those that result in the derecognition of the instrument. This also includes the application and relevance of the 10% referred to in paragraph B3.3.6 of IFRS 9 to financial assets;
 - b) considering the replacement of the interest rate benchmark that is economically similar to the previous rate and is the result of a mandatory regulatory requirement, to be accounted for as movements in the market interest rates in accordance with paragraph B5.4.5 of IFRS 9; or

- c) providing relief that the insertion of fallback provisions or actual replacement rates should not trigger the derecognition or modification of a financial asset or liability.

Changes to hedge documentation

Accounting requirements

- 22. To qualify for hedge accounting, paragraphs 6.4.1 of IFRS 9 and 88(a) of IAS 39 require that, at the inception of the hedge accounting relationship, there is formal documentation of the relationship and the entity's risk management objective and strategy for undertaking the hedge. This documentation should specify the hedged item and the nature of the risk being hedged.
- 23. In the Agenda Paper 14 *Research findings* for the December 2018 Board meeting, the staff noted that, in situations where contractual amendments do not result in derecognition, the reform may require redefining the hedged risk in the hedge documentation to make reference to the new RFR, which would result in discontinuation of the hedge relationship. This is because paragraph B6.5.26(a) of IFRS 9 states that a hedge accounting relationship should be discontinued when it no longer meets the risk management objective on the basis of which it qualified for hedge accounting (ie the entity no longer pursues that risk management objective).

Feedback received on the ED

- 24. Many of the respondents to the ED provided specific comments on this matter and proposed that the Board should amend IFRS 9 and IAS 39 to allow entities to make changes to their hedge documentation with regards to the interest rate benchmark reform without it resulting in the discontinuation of hedge accounting.
- 25. These respondents noted that hedge documentation for all hedges impacted by the reform will need to be updated to consider the IBOR transition in accordance with both paragraph 6.4.1(b) of IFRS 9 and paragraph 88(a) of IAS 39. Where IBOR is explicitly referenced in the hedge documentation as the benchmark risk, amendments to the documented risk management strategy for the replacement benchmark rates could be viewed as a de-designation event resulting in the

discontinuation of hedge accounting. However, in many of these cases the general risk management strategy of hedging interest rate risk will continue to exist and while entities could re-designate a new hedge accounting relationship based on the replacement benchmark rate, the hedging instrument will have a non-zero fair value at the re-designation date, causing significant hedge ineffectiveness

26. Furthermore, even though a new hedge accounting relationship could be designated following the discontinuation of an IBOR hedge, the discontinuation could result in the amount accumulated in OCI for a cash flow hedge to be recycled to profit or loss at that time of discontinuation. Respondents questioned whether the resulting volatility in profit or loss would provide useful information to users of financial statements and accurately reflect the performance of entities during this time of transition.
27. A few respondents also suggested that, to facilitate the transition of IBORs to the new benchmark rates, the hedge documentation could anticipate the effects of the reform by referencing both IBOR and the replacement rate for the hedging instrument, hedged item and hedged risk. For example, the hedge documentation of a hedging relationship affected by the reform would refer to both IBOR and the RFR in a particular jurisdiction as the hedged risk. Respondents noted that this would give entities confidence that new hedges would not fail hedge accounting upon transition to RFR while easing the operational burden of amending the hedge documentation after transition.
28. Other respondents also noted that existing hedge accounting relationships may also require updates to hedge effectiveness assessments and/or measurement to address timing differences in transition of rates for the hedged item and hedging instruments to a qualitative effectiveness assessment approach, where previously more quantitative approaches were applied as terms were perfectly matched. This might be the case where sufficient historic data points are not available to perform a regression analysis on the replacement benchmark rate.
29. Examples of other changes in the hedge documentation that might require further consideration from the Board, include (but may not be limited to):
 - (a) For IBOR hedges entered into prior to transition, the hedging instrument, hedged item and hedged risk may need to be redefined in

the hedge documentation to reference to new benchmark interest rates. Amendments to the hedge documentation might also include a spread over RFR used to minimise value transfers at the time of transition.

- (b) Hedge documentation may need to be amended in situations where the reform creates sources of ineffectiveness which did not exist at the inception of the hedge. For example, assuming a hedge relationship has ineffectiveness as a result of the reform, amendments to hedge documentation would be necessary to allow the resulting ineffectiveness to be measured.
- (c) Once the hedged item is amended, the hypothetical derivative may need to be redefined in the hedge documentation. Respondents noted that additional ineffectiveness may arise if the new hypothetical derivative is required to have a zero fair value at inception (ie when the hedge documentation is amended).

Potential approaches identified

- 30. Respondents noted that the situations described in paragraphs 24-29 could affect a significant number of hedge accounting relationships, introducing additional accounting complexity without providing additional useful information about how interest rate risk is managed by entities affected by the reform.
- 31. The approaches recommended by respondents included the following:
 - a) developed a principle for ensuring that hedge accounting is not discontinued due to changes in hedge documentation that are a direct consequence of the reform. For example, when the documented hedge risk is specified in terms of IBOR and it is updated to reflect the new RFR, any change in the hedge documentation necessary to reflect the new RFR should not result in discontinuation of hedge accounting.
 - b) consider limited scope amendments (ie exceptions) to IFRS 9 and IAS 39 to allow changes to hedge documentation when those changes are required due to the reform, similar to the Novation amendments that were made to IAS 39.
 - c) if a one-off relief for the amendment of hedge documentation without triggering discontinuation cannot be provided, consider allowing new hedge

accounting designations to reference both the IBOR and new RFR rate as the hedged risk for those hedges impacted by the reform in order to provide continuous hedge accounting throughout the transition period.

- d) Similarly, if entities are not permitted to amend the hedge documentation, the Board should provide relief from the immediate recycling of OCI amounts to profit or loss by considering the new hedge accounting relationship to be a continuation of the old relationship.

Question for the Board

Question for the Board

Does the Board have any questions or observations on the matters or potential approaches identified by respondents, that are discussed in this paper?