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Project	**IBOR Reform and its Effects on Financial Reporting—Phase 2**		
Paper topic	Feedback analysis—Amendments to hedging relationships		
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1. Introduction

1. This paper addresses feedback received on Question 2 of the Exposure Draft *Interest Rate Benchmark Reform—Phase 2* (Exposure Draft) regarding the proposed amendments to hedging relationships required by interest rate benchmark reform (the reform).

2. This paper is structured as follows:

   (a) Summary of staff recommendations (paragraph 3);

   (b) Summary of the proposals in the Exposure Draft (paragraphs 4–5);

   (c) Feedback analysis (paragraphs 6–17);

   (d) Staff analysis and recommendations to clarify the proposed amendments (paragraphs 18–35); and

   (e) Question for the Board (Section 6).

2. Summary of staff recommendations

3. The staff is not recommending any substantial changes to the amendments proposed in the Exposure Draft that would require an entity to amend the formal

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designation of a hedging relationship to incorporate the changes required as a result of the reform. However, we are recommending the following minor drafting changes to the proposed amendments in paragraphs 6.9.7–6.9.10 of IFRS 9 and 102O–102R of IAS 39:

(a) refer to the examples of modifications required by the reform (in proposed paragraph 6.9.4(a)–(d)) as part of the changes required to the hedging relationship;

(b) include the designated hedged portion as a required change to the hedged item; and

(c) clarify that entities must make the changes to hedging relationships by the end of the reporting period during which uncertainty with respect to a specific element of the relationship has been resolved.

3. Proposals in the Exposure Draft

4. The Exposure Draft proposed in paragraphs 6.9.7 of IFRS 9 and 102O of IAS 39 that entities would amend the formal designation of a hedging relationship to reflect the modifications and/or changes made to the hedged item and/or hedging instrument as a result of the reform. The Exposure Draft limited these changes to:

(a) designating an alternative benchmark rate as a hedged risk;

(b) amending the description of the hedged item so that it refers to an alternative benchmark rate;

(c) amending the description of the hedging instrument so that it refers to an alternative benchmark rate; and

(d) for IAS 39 only, amending the description of how the entity will assess hedge effectiveness.

5. Paragraphs 6.9.8–6.9.10 of the proposed amendments to IFRS 9 and paragraphs 102P–102R of the proposed amendments to IAS 39 stated that:

(a) The designation of a hedging relationship could be amended more than once (as described in paragraph BC50, this is because the interest rate

benchmark reform could affect the hedged risk, hedged item and hedging instrument at different times).

(b) Amending the designation of the hedging relationship does not constitute the discontinuation the hedging relationship nor the designation of a new hedging relationship.

(c) If an entity makes changes to the financial instruments designated in a hedging relationship, or to the hedging relationship, other than those required by the reform, the relevant requirements in IFRS 9 or IAS 39 have to be applied first to determine whether those changes result in the discontinuation of hedge accounting. If those changes do not require the discontinuation of hedge accounting, the entity would make the changes required by paragraph 6.9.7.

(d) As and when an entity changes the hedge designation as required, the other requirements in paragraphs 6.9.11–6.9.17 of IFRS 9 or 102S–102Z of IAS 39 would be applied as relevant.

4. Feedback from comment letters

6. Most respondents agreed with these proposals in the Exposure Draft. They said the proposed amendments generally enable an entity that has modified financial instruments as a direct consequence of the reform to continue to apply hedge accounting to those hedging relationships. Respondents noted that the objective of hedge accounting is to represent the effect of an entity's risk management activities in the financial statements and, in this regard, the replacement of interest rate benchmarks is an unavoidable event that is unrelated to the entity's risk management activities. Accordingly, these respondents said that discontinuing hedge accounting and affecting profit and loss solely due to the events caused by the interest benchmark rate reform would not necessarily provide useful financial information to users of financial statements. In respondents’ view, continuing hedge accounting when making the changes required by the reform also corresponds with the Board’s rationale for issuing the Phase 1 amendments in September 2019.

7. Other respondents also commented that the required changes to the hedging relationship correspond with the practical expedient proposed in the Exposure Draft to account for modifications directly required by the reform.[1] This is because changes in hedge documentation that are necessary to reflect modifications required by the reform are not expected to represent a change in an entity's general risk management strategy and risk management objective for hedging underlying risks. Instead, these hedging relationships would generally continue to be either hedging the exposure to variability in cash flows, (for a cash flow hedge), or hedging the exposure to changes in fair value (for a fair value hedge), albeit now associated with movements in an alternative benchmark rate.

8. However, notwithstanding their agreement with the proposed amendments, many respondents requested some clarifications about the scope and the timing of the required changes to the hedging relationships. These comments and suggestions from respondents are set out in the below sections.

9. Some respondents also requested guidance and clarification on how to account for the approaches that central clearing houses are expected to use to replace (rather than modify) hedging instruments. These comments and staff analysis of this matter is discussed in Agenda Paper 14G for this meeting.

4.1 Scope of the required changes

10. Many respondents commented that the list of required changes specified in paragraphs 6.9.7 and 102O of the Exposure Draft is too narrow. These respondents said that the changes listed in those paragraphs appear to be limited only to the alternative benchmark rate that replaced the existing benchmark rate as described in paragraph 6.9.4(a) of the Exposure Draft. They noted that entities may describe the hedged risk and hedged items in different ways in their existing hedge documentation and, therefore, other changes—ie in addition to replacing the existing benchmark rate with an alternative benchmark rate—may be required as a direct consequence of the reform. Depending on the entity's specific hedge documentation, such other changes may include those related to reset dates or spreads or the discount rate specified for measuring the fair value of the

[1] The practical expedient proposed in paragraph 6.9.3 of the ED would require entities to apply paragraph B5.4.5 of IFRS 9 to account for modifications required by the reform

hypothetical derivative or the hedged item. Respondents therefore said the other examples listed in paragraph 6.9.4(b)–(d) are equally relevant.

11. Respondents suggested various ways in which the proposed wording in the Exposure Draft could be clarified/expanded to address the concerns raised, for example:

    (a) expand the scope of changes required to the hedge designation as set out in proposed paragraphs 6.9.7 and 102O to include other changes that are required by the reform, such as those listed in paragraph 6.9.4(b)-(d) of the proposed amendments IFRS 9;

    (b) clarify the wording in paragraphs 6.9.7(b) and 102(b) to 'refer to an alternative benchmark rate or to reflect those changes necessary to effect the reform on an economically equivalent basis'; or

    (c) delete the specific changes listed in paragraphs 6.9.7 and 102O (a)–(c) and instead require the formal designation of the hedging relationship to be amended 'to reflect only changes to the hedge designation that are necessary to achieve the accounting outcomes described in paragraphs [X–X] for hedge relationships where there have been changes to the hedging instrument and/or hedged item that are required by the reform in accordance with [proposed] paragraph 6.9.3.'

12. Many respondents also commented that the proposed wording in paragraphs 6.9.7 and 102O could be interpreted to unnecessarily limit the changes to the hedge designation required as a result of the reform only to the hedged risk, whereas changes to the designated portion of the hedged cash flows might also be required.

13. Respondents noted that the current wording could be interpreted to require the changes to the hedged item to refer only to the alternative benchmark rate, and therefore disallow designations of 'a risk-free rate (RFR) plus a transition spread' which would represent the economically equivalent replacement of the original benchmark portion of cash flows, fair values or risk originally designated. They noted that when the derivative designated as the hedging instrument is amended from the existing interest rate benchmark to 'RFR plus a spread' (e.g. £ LIBOR to SONIA), the hedge ineffectiveness will increase when the designated hedged portion is changed to reflect only the alternative benchmark rate (RFR) (i.e. without

the corresponding spread). Therefore, to mitigate this ineffectiveness ie so that it does not lead to ongoing ineffectiveness in the hedging relationship, these respondents asked the Board to clarify that the hedged portion could be designated as the alternative benchmark rate plus a spread.

14. A few respondents also said that entities may make other changes to the hedging relationships that are as a result of, but not a direct consequence of, the reform, for example by including a basis swap as a new hedging instrument used to mitigate timing differences between changes made to the hedging instruments and changes made to the hedged items, or to manage ineffectiveness arising from the difference in compounding of the benchmark rates used for cash products and for derivatives.

4.2 Timing of making the required changes to the formal designation

15. A few respondents commented that the wording in proposed paragraphs 6.9.7 of IFRS 9 and 102O of IAS 39 does not appear to allow any flexibility in the timing of when entities must make updates to hedge documentation. They noted that whilst this strict wording would address any concerns of ‘cherry picking’ the timing of such updates in order to achieve a desired accounting outcome, it could create two potential issues:

    (a) entities seemingly would be prevented from applying approaches that would require a delay in updating hedge documentation, for example designating a separately identifiable component as a hedged item only when the ‘reasonable expectation’ criteria proposed in paragraphs 6.9.16 and 102Y is met, rather than “as and when” the Phase 1 relief falls away due to a contract modification that resolves an uncertainty; and

    (b) given the possible significant volume of contract modifications of hedged items and/or hedging instruments due to interest rate benchmark reform, it may not be practical for entities to update all their hedge documentation immediately “as and when” these changes occur.

16. Some of these respondents suggested that in this context, it would be helpful if the amendments clearly state that an entity would be allowed to change the hedge documentation and hedge designation multiple times and in any order for:

    (a) the change of the hedged item,

(b) the change of the hedging instrument or instruments (even if there is still "uncertainty" on the hedged item) and/or

(c) the change of the designated risk component.

17. Others asked the Board to provide entities with some flexibility to amend the designation of their hedging relationships within the reporting period. For example, some suggested that entities be allowed to amend the hedge designation at any point during the period between when the uncertainty arising from the reform is no longer present and the end of the reporting period.

5. Staff analysis and recommendations

5.1 Scope of the required changes

Including all the examples listed in paragraph 6.9.4

18. When the Board discussed whether to provide an exception from the requirements in IFRS 9 and IAS 39 so that hedging relationships could be amended as a result of the reform, the Board decided to propose that a hedging relationship would be amended to reflect those modifications that are required as a direct consequence of IBOR reform and are done on an economically equivalent basis.[2]

19. For the purposes of the Exposure Draft, paragraph 6.9.3 used the phrase 'modifications required by the reform' to refer to modifications that are required as a direct consequence of the reform and are done on an economically equivalent basis. Paragraph 6.9.4 lists the following as examples of modifications that would be required by the reform:

(a) the replacement of an existing interest rate benchmark with an alternative benchmark rate or effecting such a reform of an interest rate benchmark by changing the method used to calculate the interest rate benchmark;

(b) the addition of a fixed spread to compensate for a basis difference between an existing interest rate benchmark and an alternative benchmark rate;

[2] Refer to December 2019 IASB Update (https://www.ifrs.org/news-and-events/updates/iasb-updates/december-2019/#7)

(c) changes to the reset period, reset dates or the number of days between coupon payment dates that are necessary to effect the reform; and

(d) the addition of fallback provisions to enable any of the changes described in (a)–(c) to be effected.

20. Paragraphs 6.9.7 and 102O in the Exposure Draft did not themselves refer directly to these examples when describing the changes to the designation of the hedging relationship. However, paragraphs 6.9.8 and 102P in the Exposure Draft stated the following (emphasis added):

> If changes are made in addition to those changes required by interest rate benchmark reform to the financial asset or financial liability designated in a hedging relationship (as described in paragraph 6.9.3 or 6.9.5) or to the designation of the hedging relationship (as required by paragraph 6.9.7 and 102O)…

21. In addition, paragraph BC47 of the Basis for Conclusions on the Exposure Draft stated the following:

> Accordingly, the Board decided that if a change in the basis for determining the contractual cash flows for a financial asset or a financial liability designated in a hedging relationship is required by the reform (ie it is within the scope of the proposed practical expedient in paragraph 6.9.3 of this Exposure Draft), it would be consistent with the Board's objectives for Phase 2 to require the hedging relationship to be amended to reflect those changes without requiring discontinuation of that hedging relationship.

22. Therefore, the staff is of the view that the examples listed in paragraph 6.9.4 (a)–(d) are included as part of the proposed amendments in paragraphs 6.9.7 and 102O. However, for the avoidance of doubt, the wording of those proposed paragraphs could be clarified in this respect when we draft the final amendments.

Changes to the designated hedged portion

23. Many respondents commented that the proposed requirement to amend the description of the hedged item in paragraph 6.9.7(b) is too narrowly defined. These

respondents said that the wording in this paragraph implies that the only change an entity is permitted to make is to change the description of the hedged item to refer to an alternative benchmark rate and, therefore, that changes to the designated hedge portion are not permitted.

24. The designated hedged portion represents the portion of the cash flows of the hedged item that is hedged for changes in the hedged risk. For example, in a fair value hedge of a fixed rate loan, the hedged portion refers to the portion of the fixed rate coupon plus the principal that is hedged for changes in the benchmark rate. Therefore, if the fixed rate on a loan is 6% when the IBOR rate is 5%, an entity could designate a fair value hedge in which the hedged portion is defined as the coupon cash flows equivalent to 5% plus the principal on the loan (this would match the fixed leg on the derivative).

25. Most of the respondents that commented on this point wanted clarification that the hedged portion could be amended to include the basis spread between the IBOR and RFR rates at the date the RFR is designated as the hedged risk, ie the spread referred to in paragraph 19(b).[3] Therefore, if at the date the hedge designation is changed, IBOR is 4% and RFR (which is assumed to be typically 10 basis points lower than IBOR) is 3.9%, the entity could change the hedged portion to the equivalent of 4.9% (original IBOR portion less spread of 10 basis points) plus the principal on the fixed rate debt.

26. The staff agree with respondents that amending the designated hedged portion is needed when the hedging relationship is amended to reflect the modifications required by the reform. If the designated hedged portion is not amended, it would likely lead to differences arising between the hedged item and the hedging instrument, leading to ineffectiveness that is not necessarily representative of the true effectiveness of the hedging relationship. This is because hedging instruments are expected to be modified on an economically equivalent basis, so for a derivative designated in a fair value hedge as described in paragraph 25, the fixed leg will be modified to 4.9% (5% - 10 basis points spread).

[3] Reproduced from paragraph 6.9.4 (b) of the Exposure Draft

27. Furthermore, we are of the view that clarifying the wording in proposed paragraphs 6.9.7(b) and 102O(b) to include amendments to the hedged portion would be consistent with the Board's intention to require changes to the description of the hedged item to reference an alternative benchmark rate and would not result in a substantial change to the requirements proposed in the Exposure Draft.

Other changes to the hedging relationship

28. Although we understand entities' desire to manage and limit ineffectiveness that could arise as a result of the reform, we think it is important to maintain strict boundaries around the type of changes that are made to hedging relationships without having to discontinue applying hedge accounting. This is because the Board's objective for the Phase 2 amendments have not only been to support entities in applying the IFRS requirements, but also to provide users of financial statements with useful information about the effect of the reform on an entity's financial statements. For this reason, the Board have limited the changes to those that are required by, or are a direct consequence of, the reform.[4]

29. We are of the view that adding a basis swap or introducing an interim step as described in paragraph 14 of this paper are optional/voluntary decisions that an entity may make in order to manage ineffectiveness. But these decisions are not 'required' as such by the reform. In practice, basis swaps are usually done on an aggregated/entity basis and not on individual hedging relationship basis.

30. Therefore, the staff is not recommending widening the scope of the changes to the hedging relationships to include options an entity may choose to take to avoid ineffectiveness. The staff note that these optional changes might be valid risk management practices and that the Exposure Draft included proposed requirements in paragraphs 6.9.8 and 102P that are relevant when an entity makes changes to a hedging relationship that are not required by the reform.

5.2 Timing of making the required changes to the formal designation

31. The staff acknowledge the concerns raised by respondents about the perceived inflexibility about when changes to the hedging relationships must be made,

[4] Also refer to AP14A for further discussion on this

especially in the context of the large volume of changes that entities may need to make in a relatively short period of time.

32. Proposed paragraphs 6.9.7 and 102O required the changes to the hedging relationships to be made 'as and when' uncertainty arising from interest rate benchmark reform is no longer present. This is because the Phase 1 amendments, issued in September 2019, already made provisions for circumstances when uncertainties arising from the reform were resolved at different times for different elements of the hedging relationship.

33. In drafting the Exposure Draft, the staff thought about requiring the changes to the hedging relationship to be made on a specific date, ie the date that uncertainty is resolved. This would have aligned with the current requirements in both IFRS 9 and IAS 39 that a hedging relationship is designated, and hedge accounting applied, from a specific date—ie the date specified as the inception of the hedging relationship. However, at the time, the staff considered that requiring the changes to made on the specific date that uncertainty is resolved, would require entities to identify the exact date on which uncertainty is resolved and immediately make amendments to the hedging relationship, which would be operationally difficult and burdensome to do. For that reason, the Exposure Draft proposed that the respective changes to the hedging relationship are made 'as and when' uncertainty is resolved.

34. In the staff's view, the intention in the Exposure Draft was to provide entities with some flexibility in making the required changes to the hedging relationships. However, to address respondents' concerns about the wording of the proposals, the staff recommends clarifying the requirement to explicitly state that the required changes to the hedging relationships have to be made by the end of the reporting period during which uncertainty with respect to a specific element of the relationship has been resolved.

35. With respect to clarifying that changes to hedging relationships could be made at different times for the different elements in the relationship, the staff note that paragraph BC43 of the Basis for Conclusions on the Exposure Draft stated that, in most cases, uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows would be resolved when the underlying financial instruments designated in the hedging relationship have been modified or changed

to specify the timing and the amount of interest rate benchmark-based cash flows by reference to the alternative benchmark rate. For that reason, paragraphs 6.9.10 and 102R of the Exposure Draft acknowledged that changes to different hedging relationships could be made at different times, and changes to a particular hedging relationship could be made more than once, depending on when the modifications/changes to the hedged item and hedging instruments respectively are made. We therefore think changes to the proposed amendments are not needed in this regard.

6. Questions for the Board

Questions for the Board

1. Does the Board agree with the staff recommendations to finalise the proposals in the Exposure Draft related to the changes required to hedging relationships, subject to the following clarifications:

   (a) incorporate reference to the examples of modifications required by the reform as part of the changes required to hedging relationships;

   (b) include specific reference to the designated hedged portion as part of the required changes to the hedged item; and

   (c) clarify that the changes to the hedging relationships have to be made by the end of the reporting period during which uncertainty with respect to a specific element of the relationship has been resolved.